Raymond Chabot Grant Thornton

IFRS Adviser Alert

COVID-19: Accounting implications for CFOs – Considerations when preparing financial statements and using alternative performance measures

August 2020

Executive summary

The Grant Thornton International IFRS team has published *COVID-19: Accounting implications for CFOs – Considerations when preparing financial statements and using alternative performance measures*.

Overview

Preparers of financial statements are now having to think about how, where and in what form they should report COVID-19 in their financial statements. It is important to not only comply with the guidance set out in IFRS, but also ensure that the financial statements are an effective part of the wider communication with stakeholders.

The publication sets out various ways to enhance communication on how the pandemic has impacted the financial position and performance of any reporting entity. These include sensitivity analysis, the use of alternative performance measures and changing line items that have previously been disclosed within the financial statements.

Resource

The publication *COVID-19: Accounting implications for CFOs – Considerations when preparing financial statements and using alternative performance measures* follows this *IFRS Adviser Alert*.

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COVID-19: Accounting implications for CFOs

Considerations when preparing financial statements and using alternative performance measures

Preparers of financial statements are now having to think about how, where and what form they should report COVID-19 in their financial statements. We believe it is important to not only comply with the guidance set out in IFRS, but also ensure the financial statements are an effective part of the wider communication with stakeholders.

We set out below various ways to enhance communication on how the pandemic has impacted the financial position and performance of any reporting entity. These include sensitivity analysis, the use of alternative performance measures and changing line items that have previously been disclosed within the financial statements.

What do entities need to consider when adding new disclosures?

IAS 1 encourages entities to add new disclosures into financial statements. However, it sets out some strict criteria, particularly on the face of the main statements, as to how this should be done. In the current environment, the presentation of additional line items should be accompanied by sufficient disclosures defining them, explaining their composition, and providing information that improves their relevance.

Adding new disclosures does not mean that previously reported Alternative Performance Measures (APMs) should be changed. In our view, previously reported APMs should not be changed and we set out our reasons for this below.

What about areas outside the financial statements?
The financial statements are just one part of the communication with stakeholders. Depending on jurisdiction requirements, an annual report typically includes the financial statements, a management commentary and information about governance, strategy and business developments (often including corporate and social responsibility). It is important the annual report is considered holistically to ensure it delivers a consistent and coherent message about COVID-19 to the investors and other stakeholders ('users').

IAS 1 acknowledges an entity may present, outside the financial statements, a financial review that describes and explains the main features of the organisation's financial performance and financial position, both locally and internationally. Reports and statements presented outside financial statements are outside the scope of IFRS.

Even though reports and statements outside financial statements are excluded from the scope of IFRS, they are not out of scope of regulation. If users are told what they need to know in a well-constructed and logical manner, it's highly likely the reporting entity will have done a great deal to comply and satisfy local regulatory requirements. In certain jurisdictions there may be certain reconciliations required between APMs and IFRS.

Remember it is still important to make sure certain required information is placed either in the financial statements or in the notes. Particular attention should be given to making sure that any disclosures placed outside the financial statements are not specifically required by IFRS to be included within the financial statements.

When reporting on the economic consequences of the pandemic on the reporting entity a key factor is considering whether the message communicated is consistent and coherent and aligns with any narrative contained elsewhere in the annual report.

Our view is that when drafting content for the annual report and the financial statements, preparers should question:

- what is important to the business and what are its main objectives?
- are these objectives consistent throughout the annual report?
- is the right level of emphasis being placed on the COVID-19 aspects?
- are the messages about the impact of COVID-19 consistent?
- are the financial statements using the same terminology between the financial statements and the management commentary? For example, if the statement of financial position is referred to as the balance sheet, is this done throughout the report – rather than switching between the two titles?
- where the annual report includes alternative performance measures (APMs), have they all been properly reconciled to IFRS-based amounts included in the financial statements?

Given the uncertainty, should sensitivity measures be included?

Due to the level of uncertainty that continues to surround the pandemic, we would encourage entities to include sensitivity analysis to provide insight into the impact it has had in the past and might have in the future. Entities should provide separate disclosure in the notes to the financial statements, or elsewhere, with detailed analysis of the impact of the coronavirus outbreak on their financial position, performance and cash flows.

Such disclosures may also include sensitivity analysis on uncertain estimates, as well as management information about measures taken to address the disruption in their operations.

Making estimates and judgements is an integral part of preparing financial statements. Effective disclosures about the most important estimates and judgements enable investors to understand your financial statements. However, given the pervasiveness of estimates and judgements, deciding which of them should be included – and what to say about them – can be challenging.

How should an entity disclose key estimates?

Most of the numbers in a set of financial statements prepared under IFRS are based on estimates to some degree – even relatively simple amounts such as depreciation and the cost of inventories. Several of these estimates involve predictions about the future. Many estimates are routine and the range of reasonably possible alternative outcomes is small. However, investors and other stakeholders need to know more about the major sources of estimation uncertainty arising from COVID-19 to properly understand the financial statements.

"Due to the level of uncertainty that continues to surround the pandemic, we would encourage entities to include sensitivity analysis to provide insight into the impact it has had in the past and might have in the future."

IAS 1 explains the overall requirements for disclosures about estimates. The focus is on assumptions management is making about the future, and other major sources of estimation uncertainty at the end of the reporting period, when there is a significant risk of a material adjustment within the next financial year.

IAS 1 requires disclosure about the assumptions made and the nature and carrying amounts of the assets and liabilities affected. It does not prescribe the exact information you should disclose about these assumptions but gives examples of the types of information:

- the nature of the assumptions
- sensitivity of carrying amounts
- expected resolution/range of reasonably possible outcomes
- changes made to past assumptions.

Some standards also include disclosure requirements about particular estimates. For example:

- IAS 36 'Impairment of Assets' specifies disclosures about impairment testing
- IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' requires disclosures about uncertainties and major assumptions affecting provisions
- IFRS 13 'Fair Value Measurement' requires information about how fair values have been estimated.

When should an entity present additional line items and subtotals?

An entity should present additional line items when it is relevant to the understanding of an entity's financial position, performance and cash flows. Whilst it is therefore allowed to add lines in respect of COVID-19, it is important to ensure COVID related matters are not given undue prominence. In our view, it would not be appropriate to add columns that exclude the impact of COVID-19 in the financial statements.

In respect of the above view, IAS 1 requirements would not allow such a presentation. It states that total comprehensive income comprises all of 'profit or loss' and of 'other comprehensive income'. These are defined as

- 'the total of income less expenses, excluding the components of other comprehensive income' for profit or loss and
- 'items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRS' for other comprehensive income.

In other words, due to the above IAS 1 requirements it would not be appropriate to present only some items of income and expenses or fictitious items of income and expenses.

These items should be classed as non-recurring or unusual, not extraordinary. An unusual or new type of transaction is more likely to be material than a routine or regularly occurring transaction of the same size.

IAS 1 provides some examples of items considered 'unusual' that could warrant disclosure that may otherwise fall below materiality thresholds, and these could be relevant to COVID-19:

- write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs
- restructurings of the activities of an entity and reversals of any provisions for the costs of these restructurings
- disposals of items of property, plant and equipment
- disposals of investments
- discontinued operations
- litigation settlements
- other reversals of provisions.

What should an entity do if it intends to introduce a "new" APM?

APMs are performance metrics that are either not defined in IFRS or are calculated differently from the requirements in IFRS. Many entities disclose APMs in the financial statements or elsewhere in the annual report. Examples include:

- revenue including share of joint ventures and associates
- EBITDA
- measures of profit that exclude certain items.

Although APMs are not defined in IFRS, some limited guidance in this area is provided.

IAS 1 requires reporting entities to disclose additional 'headings and subtotals' in the statement of profit or loss and other comprehensive income when relevant to understanding the entity's financial performance. Recent changes to IAS 1 require that, these amounts should be:

- made up of amounts recognised and measured in accordance with IFRS
- presented and labelled clearly and understandably
- consistent from period to period
- be displayed with no more prominence than the required subtotals and totals.

The Basis for Conclusions to IAS 1 (BC56) discusses operating profit (which is currently not defined in IFRS, but will be if the current Exposure Draft on 'General Presentation and Disclosures' is published as a replacement Standard for IAS 1 in the future). When an entity includes such a subtotal for results of operations, it should include all expenses and income that are of an 'operating nature' – even if some items occur irregularly or infrequently or are unusual in amount. For example, it would be inappropriate to exclude items clearly related to operations such as inventory write-downs and restructuring and relocation expenses. Similarly, it would be inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortisation expenses.

Why are they an issue?

- the use of APMs is increasing and many entities will see them as an important way to communicate the effects of the COVID-19 on its operations and activities
- used appropriately APMs can efficiently and effectively explain how the pandemic has affected the reporting entity. But by contrast, non-transparent, inconsistent or selective use will cause confusion. Therefore, using different APMs to communicate the effects of COVID-19 means there is a risk of confusing or even misleading users of financial information is they are not clearly described or disclosed
- securities regulators around the world have been clearly indicating they will challenge organisations that, in their view, are using APMs inappropriately (see below)
- APMs are useful when readers of the financial statements are made aware they are being used by management to monitor the business and make decisions over time, and therefore in light of COVID-19 are enabling management to monitor the full impact of the pandemic on all aspects of its operations
- however, APMs can also be used to mask underlying performance or show the reporting entity in an inappropriately flattering light, so significant caution should be taken in their use during the pandemic, particularly any newly created measures.

Regulators across the world have set out their expectations about reporting on APM measures and in many countries reminders have been issued confirming that what has previously been issued will be enforced.

If using APMs, what should you do?

Best practice principles you should consider when using APMs are to:

1 define your APMs and explain the basis of how they are calculated. Some APMs may be self-evident, but others could have a variety of possible methods of calculations
2 explain why you are using particular APMs and why the ones used are useful
3 label your APMs clearly and distinguish them from IFRS disclosures
4 ensure your measures are unbiased, for example, non-recurring gains should be treated in the same way as non-recurring losses and that you are being transparent with your definition of 'non-recurring'
5 reconcile to IFRS disclosures if it not immediately clear where the numbers come from
6 use your measures consistently each year and explain any changes to the disclosures, together with reasons. Make adjustments consistent with those made to comparatives
7 avoid presenting the APMs with more prominence than the IFRS disclosures
8 include comparative disclosures for all APMs (with reconciliations).

These best practice principles are consistent with those issued by the European Securities Markets Authority (ESMA) in June 2015. ESMA regulates EU financial markets. Recently ESMA issued a publication reminding entities of the main principles of the APM guidelines. Their publication, 'Questions and Answers, Guidelines on APMs' (issued in April 2020), recommends entities to use caution when adjusting APMs and when including new APMs to address the impact of COVID-19. In addition, in order to make the disclosures effective encourages:

- descriptive text about the modifications made, the assumptions used and the impact of COVID-19
- details of measures taken or expected to be taken by entities in order to address the impact of COVID-19 outbreak on their operations and performance.

In addition, on 29 May 2020, the International Organisation of Securities Commissions (IOSCO), clarified the importance of ensuring in the current environment APMs are not misleading. IOSCO reminded users of financial statements that they should carefully evaluate the appropriateness of adjustments or alternative profit measures because not all COVID-19 effects are non-recurring and there may be a limited basis for management to conclude that a loss or expense is non-recurring, infrequent or unusual (ie not all COVID-19 effects are non-recurring). This includes where the impacts of COVID-19 cross over a reporting date. IOSCO noted it could be misleading to describe an adjustment as COVID-19 related, if management does not explain how an adjusted amount was specifically associated with COVID-19. Given this, we caution issuers from characterizing an impairment as COVID-19 related, where indicators of impairment existed prior to the pandemic that are unrelated to COVID-19. Additionally, characterising hypothetical sales and/or profit measures (eg had it not been for the effect of COVID-19 the company's sales and/or profits would have increased by XX%) as non-GAAP financial measures would not be appropriate.[1]

On that same day, the Canadian Securities Administrators (the Canadian regulator) issued a similar statement reminding reporting entities on the importance of disclosing high quality information to investors on the pandemic, and confirming their approval of IOSCO's report.

Canada was not alone. On 20 May 2020 the Financial Reporting Council (FRC) in the United Kingdom updated its COVID-19 related guidance for companies and outlined its expectations regarding the reporting of 'Exceptional or similar items and Alternative Performance Measures'.[2] This report reminded preparers that APMs should also be presented consistently year on-year. However, the FRC noted there may be circumstances where the COVID-19 crisis has, for example, resulted in a company making changes to its operations or business model. These may result in changes to the APMs that are used to manage and monitor the business. In these circumstances, readers should be informed of any such changes and given an explanation of why they provide reliable and more relevant information. APMs which attempted to provide a measure of 'normalised' or 'pro-forma' results, excluding the estimated effect of the COVID-19 crisis, were likely to be highly subjective and, therefore, potentially unreliable. This is in addition to the subjectivity arising around which costs to exclude, in most cases COVID-19 is likely to have resulted in reductions in revenues. Any adjustment for lost revenues would be hypothetical and could not be reflected reliably in an APM. The FRC concluded they did not expect companies to provide these measures; for example, by including them in a 'third-column' income statement presentation.

> "IOSCO has clarified the importance to ensure in the current environment APMs are not misleading."

[1] For IOSCO's complete report dated 29 May 2020 please refer to: https://www.iosco.org/news/pdf/IOSCONEWS568.pdf

[2] For the FRC's complete report dated 29 May 2020 please refer to: https://www.frc.org.uk/getattachment/9fff0029-9be2-4cf8-8f9d-932c3689e99e/COVID-19-Resources-action-the-future_Final.pdf

How can APMs be used to reflect the impact of the COVID-19 pandemic?

Entities can use APMs in several ways to provide the much-needed communication on the impact of COVID-19. For example, through adding extra line items in their primary financial statements, or additional disclosures in the notes to the financial statements.

It is important that entities determine what is relevant to understanding the financial statements and what the appropriate COVID-19 disclosures should be. This will need judgement, and entities should consider whether these should just be in the form of those that impact profit or others such as those on the statement of financial position or cashflows.

It is important entities ensure that all APM's used are appropriately defined and reasoning is provided. In addition, entities should highlight why the measures used are useful and how management believes they will help investors better understand the operations of the reporting entity.

Types of costs and disclosures in relation to COVID-19 entities may want to explain are as follows:

- incremental costs – additional costs incurred as a result of the coronavirus
- unrecovered costs – costs already incurred but cannot be recovered as a result of COVID-19
- detailed analysis disclosure – detailed explanation and narrative description of the impact of COVID-19 as a separate note
- period analysis – disclosure that demonstrates which periods the pandemic impacted the financial statements.

APMs that are 'as if measures', in our view, would not be suitable to communicate the impact of COVID-19. These measures relate to adjustments made to APMs in order to normalise operations, such as including estimates of lost revenue to show what results would have been without the effects of COVID-19.

"It is important that entities determine what is relevant to understanding the financial statements and what the appropriate COVID-19 disclosures should be."

How can communication be kept clear, and why is it so important?

Some areas of the financial statements can prove difficult for non-experts to follow and understand. Whilst an attempt can be made to simplify wording, sometimes in order to meet the requirements of the standards there is a limit to how much simplifying that can be done. Instead, the financial statements can include commentary on more complex areas in plain English. Doing this will assist users' interpretation and understanding of the financial statements.

How should such commentary be presented?

In addition to the required disclosures, additional text can be added, which is separated from the rest of the information. This can be done using tables, boxes or highlighted colours.

We recommend you explain these additional disclosures and their purpose at the beginning of the annual report. This will prevent any confusion for the reader.

Example – 'keep it simple' disclosure

The example below provides the definition of a derivative and a hedged item and how the company uses such items:

Keep it simple

A derivative is a type of financial instrument the entity uses to manage risk. It is something that derives its value based on an underlying asset. It's generally in the form of a contract between two parties entered into for a fixed period. Underlying variables, such as exchange rates, will cause its value to change over time. A hedge is where the entity uses a derivative to manage its underlying exposure. The entity's main exposure is to fluctuation in foreign exchange risk. We manage this risk by hedging forex movements, in effect fixing the boundaries of exchange rate changes to manageable, affordable amounts. A key criterion relating to cash flow hedges over forecast transactions relates to the requirement for the hedged cash flows to be highly probable. The requirement to meet this highly probable assessment is crucial. The highly probable assessment therefore takes into account COVID-19's impact, based on the facts and circumstances that exist at the balance sheet date.

Example – keep it simple explanatory paragraph

Keep it simple… explained

The aim of the 'keep it simple' text is to provide explanations of more complex areas in plain English. The entity has provided this additional commentary to assist the readers' understanding and interpretation of the financial statements.

Should the “incremental” consequences of COVID-19 be assessed?

Assessing the incremental consequences of the pandemic costs will involve significant judgement. Incremental costs are those costs that have occurred as a result of the COVID-19 outbreak that would not have been incurred had the pandemic not happened. These costs should be directly attributable to COVID-19, separable and not expected to re-occur after the pandemic. Therefore, separating them would be a complex exercise that would require good disclosure surrounding the criteria used to identify such costs.

Examples of incremental costs include:

Costs that could be separable	Costs unlikely to be separable
Additional cleaning costs	Wages where employees cannot work
Bonus payments to employees who are working at increased personal risk	Lease payments for premises only being partially used
Termination of contract fees	Insurance paid
Personal protection equipment over and above what had previously been used	Utility costs
	Increased IT facilities to accommodate remote working
	Excess capacity costs

All costs that are disclosed as COVID-19 incremental costs should be clearly described as such to avoid ambiguity.

Will there be a level of accountability for APMs?

In conclusion, reporting entities must always be mindful that regulators are giving, and will continue to give, APMs close attention. The FRC provided some helpful insight when they signaled in a report they published that they will continue to question entities when the following conditions exist[3]:

- Definitions are not given for all APMs used.
- A term such as non-recurring is used and that description does not appear to apply in the circumstances.
- Good explanations for the use of APMs are not provided.
- A reconciliation to amounts appearing in the financial statements for each APM is not disclosed.
- APMs are displayed with greater prominence than measures directly stemming for the financial statements.
- There is no discussion of either in the IFRS results themselves or of the adjustments made to those results to arrive at adjusted profit.
- The IFRS results are not highlighted at an early point in the narrative selection of the report and accounts.
- No explanation is given for changes made in the APMs used. Changes may include changes to which APMs are presented, in how APMs are defined and in the label applied to each APM.
- Explanations are not presented of why items have been excluded from adjusted profit. The quality of explanation is particularly important when this item is not usually adjusted for by the company's peers.
- Items are excluded on the basis that removing them better reflects the underlying performance of the business and it is unclear why this is the case; for example, share based payments.

[3] For FRC's full report entitled 'Corporate Reporting Thematic Review Alternative Performance Measures November 2017' please refer to: https://www.frc.org.uk/getattachment/ff987c01-416f-4635-8dba-fdda5530f4b5/CRTR_APMs_v6.pdf

How Grant Thornton can help

Preparers of financial statements will need to be agile and responsive as the situation unfolds. Having access to experts, insights and accurate information as quickly as possible is critical – but your resources may be stretched at this time. We can support you as you navigate through accounting for the impacts of COVID-19 on your business.

Now more than ever the need for businesses, their auditor and any other accounting advisors to work closely together is essential. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

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