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MAZARS' NEWSLETTER ON ACCOUNTING STANDARDS

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EDITORIAL

Almost two months after the WHO declared the COVID-19 epidemic a pandemic, and while lockdown measures and other government decisions seek to provide answers to the health and economic crisis unfolding before our eyes, the business impacts of the disease are already very significant.

In view of this emergency, numerous players are taking action, not least the IASB, which is proposing amendments to IFRS 16 through an accelerated due process. These amendments would exempt lessees from conducting complex analyses in order to assess whether rent concessions granted by lessors are contract modifications (which would entail spreading the benefit, rather than an immediate impact in profit or loss).

This supplement also picks up last month's discussions in three key areas: impairment assessment, accounting for State support under part-time working measures, and the presentation of the statement of profit or loss.

Finally, a reminder that Accountancy Europe, an organisation representing the accounting profession in Europe, regularly updates its crisis web page, offering a complete overview of the positions and resources available at various levels against the background of COVID-19. To access this page, paste the link below in your browser: https://www.accountancyeurope.eu/professional-matters/COVID-19-resources-for-european-accountants/.

Happy reading!

Edouard Fossat Carole Masson

EUROPEAN highlights

ESMA guidelines: update of APM Guidelines in the context of COVID-19

On 17 April, the European Securities and Markets Authority (ESMA) published an update of its Q&A on the use of the Alternative Performance Measure (APM) guidelines, specifically in light of the COVID-19 pandemic.

Given the significant impacts of the health and economic crisis, the European regulator has anticipated that issuers will want to disclose new, or adjust existing, alternative performance measures in order to take account of the effects of COVID-19 on their performance and their cash flows. Under these circumstances, ESMA has called for the greatest caution, in order to avoid providing a misleading message to the markets, and reminds issuers of the importance of discipline and transparency in the use of such measures.

Because COVID-19 may have wide impacts on every aspect of an entity's financial performance, financial situation and cash flows, adapting or adding indicators could, in the view of the regulator, fail to provide transparent and useful information.

ESMA therefore urges issuers rather to provide additional details in the notes to the financial statements, in particular in order to explain how the pandemic has impacted and/or is expected to impact their operations, the level of uncertainty and the measures adopted to address the outbreak. These disclosures should also include details of the impacts of COVID-19 on the assumptions and estimates used when determining inputs to APMs, for example impairment losses, expected lease payment reductions or grants received.

Finally, the European regulator reminds issuers of some key principles, such as:

– the fact that the guidelines and the Q&A apply to all APMs (including liquidity and cash-flow measures) that are reported, both inside and outside the financial statements;

– the need to explain and justify the use of specific new or adapted existing APMs, which must not be presented with more prominence than measures directly stemming from financial statements.

The Q&A can be accessed on the ESMA web site at: https://www.esma.europa.eu/sites/default/files/library/esma32-51-370_qas_on_esma_guidelines_on_apms.pdf

A Closer Look

Rent concessions as a result of COVID-19: the IASB proposes to amend IFRS 16

1. What is the situation today?

The COVID-19 health crisis has led, or will lead, many lessors to grant rent concessions to their lessees. These are particularly prevalent in the retail sector. These concessions may in some cases be encouraged or even required by governments.

Rent concessions may take a number of forms, including rent holidays or rent reductions for a period of time, possibly followed by increased rent payments in future periods.

Under IFRS 16, the accounting impacts of changes in lease payments mainly depend on whether the changes in question meet the definition of a contract modification.

A contract modification gives rise, for the lessee, to an adjustment of the lease liability, taking account of the revised lease payments discounted at the appropriate rate (usually the lessee's incremental borrowing rate) at the contract revision date, and a corresponding adjustment to the right-of-use asset. Thus, the impact of a contract modification for the lessee will be spread over the remainder of the lease term through depreciation of that right-of-use asset.

2. The IASB is aware that application of the standard appears particularly complex, and would constitute a major challenge for lessees.

The analysis required in order to assess whether a change in rental payments represents a contract modification appears particularly complex and would be a major challenge for stakeholders during the COVID-19 pandemic. This challenge is due to the combination of the two following difficulties:

- firstly, the difficulty of assessing whether rent concessions amend the lease. This assessment requires preparers to determine whether the change of rental payments was provided for in the initial contract conditions. Such an assessment may be particularly complex in light of the high volume of leases (legal formalism, and the juridical environment specific to each). Similarly, determining whether an event as singular as a pandemic falls within the scope of contractual and/or legal terms will not necessarily be straightforward. For example, a lease, a law or a regulation applicable to a contract may contain force majeure clauses which have never addressed the specific circumstances of a pandemic. In this case, it may be difficult to conclude that rent concessions result from the strict application of the contractual clauses or of the relevant legal provisions, rather than from renegotiation;
- next, the difficulty of applying the accounting treatment required in the event of contract modifications: while it is neither complex nor onerous to account for a contract modification individually, the volume of leases concerned would demand significant resources, at a time when lessees are likely to have other, more important worries due to the pandemic.

With this in mind, the IASB held an extraordinary meeting on 17 April, and unanimously decided to amend IFRS 16. Shortly thereafter, on 24 April, an Exposure Draft was published.

3. What does the IASB's Exposure Draft propose?

In the Exposure Draft, the IASB firstly proposes to amend IFRS 16 to give lessees, and only lessees, the option to elect not to assess whether a COVID-19-related rent concession is a lease modification.

Lessors would be excluded from the scope of this practical expedient. The IASB does not currently intend to amend the standard as it applies to them.

This expedient, if adopted by a lessee, would mean that any change in lease payments resulting from COVID-19-related rent concessions would be accounted for as if the change were not a lease modification. It would therefore recognise the impact of rent concession in profit or loss for the period, and not over the residual term of the lease. In this case, the lease debt would be cleared on the basis of the original contractual flows, as if the rents had actually been paid, and the depreciation of the right-of-use would continue unchanged.

Lessees would apply the practical expedient consistently to contracts with similar characteristics and in similar circumstances.

In the Exposure Draft, the IASB proposes to apply this practical expedient only to rent concessions occurring as a direct consequence of the COVID-19 pandemic and only if all of the following conditions are met:

- the change in lease payments results in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change;
- any reduction in lease payments affects only the payments originally due in 2020, and
- there is no substantive change to other terms and conditions of the lease.

It is proposed that this amendment should be applicable to annual reporting periods beginning on or after 1 June 2020. Early application would be possible.

The amendment would have to be applied retrospectively, but the comparative figures would not be restated. Lessees would therefore recognise any difference resulting from initial application of this expedient as an adjustment to the opening balance of retained earnings (or other component of equity) at the beginning of the reporting period in which the amendment is first applied.

Finally, to accelerate the publication of this amendment, the comments period runs for just 14 days. Comments were therefore expected by 8 May.

The IASB's Exposure Draft can be consulted at: https://cdn.ifrs.org/-/media/project/ifrs-16-covid-19/ed-covid-19-related-rent-concessions.pdf?la=en

Key points to remember

- A practical expedient that would only apply to lessees, and which would mean that any change in lease payments resulting from COVID-19-related rent concessions would be accounted for as if the change were not a lease modification.
- A practical expedient that should be applied consistently to contracts with similar characteristics and in similar circumstances.
- A practical expedient that would only apply to rent concessions resulting directly from the COVID-19 pandemic, and under certain conditions, including a time-frame and occurrence within a limited period (only the reduction of rents initially due in 2020).
- A practical expedient that would apply to periods beginning on or after 1 June 2020, with the option of early application.
- A practical expedient that would be applicable retrospectively, without restatement of the comparative figures (i.e. impact in the opening retained earnings of the first year of application).
- A comments period of just 14 days, with a closing date of 8 May 2020. Final amendments are expected very shortly.

A Closer Look

Accounting impacts of the COVID-19 epidemic on corporates' 2020 financial statements: update on three key issues

In our previous supplement, we presented some of the many accounting questions arising for the 2020 interim accounts (and for accounting periods that do not coincide with the calendar year), given the already visible impacts of the COVID-19 epidemic on corporates' activities.

As discussions continued throughout April within the accounting profession, along with national standard-setters, market regulators and business representatives, this study aims to present an update on three key subjects already addressed in our previous supplement: impairment assessment for long-term assets, accounting for State support under part-time working measures, and the presentation of the statement of profit or loss .

The information presented below represents Mazars' preliminary views concerning the preparation of IFRS consolidated accounts.

1. Impairment testing of long-term assets (IAS 36)

IAS 36 requires preparers to consider, at the end of each reporting period, whether there is any indication that an entity's assets may be impaired, and to carry out an impairment test on the asset or on the cash-generating unit to which it belongs whenever such an indication is identified. These provisions apply to interim and annual reporting dates alike.

For many entities, the COVID-19 crisis during the first half of 2020 has given rise to circumstances that are indications of a possible impairment loss:

- a fall in the stock market value of the company, a subsidiary or an equity-accounted investment, below its net carrying amount;
- a significant fall in demand or prices, and consequently in operating cash flows;
- the closure of businesses, supply chain disruption, and other adverse changes in the conditions under which an asset is used.

For example, in preparing their interim accounts closed after 11 March 2020 (the date on which the WHO declared COVID-19 a pandemic) many businesses will have found indications of impairment for one or more of their cash-generating units. They will therefore have to carry out impairment tests on these CGUs in accordance with IAS 36.

During this period of great uncertainty, and while management efforts are focused coping with the short-term impacts of the crisis, it can be difficult to establish new business plans for the sole purposes of the impairment tests that have become necessary for interim reporting. Nevertheless, the cash flows used to determine the recoverable amount of the CGUs tested must reflect the best estimate of the economic conditions that will prevail over the whole lifetime of the assets. Therefore:

- if the business plans drawn up before the epidemic have become obsolete, they must be revised to reflect the expected impacts of the crisis;
- the cash flows for the current year used for the calculation of recoverable value must be consistent with the short-term cash flow forecasts established for the purposes of management of the liquidity risk;
- if economic impacts from the crisis are expected over the longer term, they must be included in the revised business plans and be reflected in the calculation of the terminal value.

In practice, business plans taking account of the impact of the COVID-19 epidemic must incorporate assumptions concerning the length of the crisis and the rebound curve, asset use conditions in the short-term, governmental support measures, changes in long-term growth prospects, etc. The determination of these assumptions must rely as much as possible on the available external sources of information.

The significant uncertainties regarding the length and severity of the impacts of the crisis, or its longer-term effects on an entity's performance, complicate the preparation of the forecasts necessary for calculating value in use. To alleviate this situation, if the entity has the capacity, a more appropriate approach would be to develop multiple scenarios, weighted by their probability of occurrence. Where value in use is based on a single cash flow scenario, it may be necessary to adjust the discount rate, applying a risk premium reflecting the uncertainties surrounding the cash flow forecasts.

Against this background significant uncertainties, explicit and appropriate disclosures about impairment tests should be provided. In particular, the key assumptions applied in cash flow forecasts must be described, including those specifically due to the COVID-19 crisis, and sensitivity tests should take account of a new magnitude in the reasonably possible changes to the assumptions. Remember that the key assumptions are not limited to the discount rate and the perpetuity growth rate applied in the calculation of terminal value, but also include the assumptions underlying the business plan over the forecast period.

The disclosures to be provided include the nature and the source of the assumptions made, an explanation of changes in these assumptions that have occurred since the end of the last reporting period, sensitivity to the key assumptions and the magnitude of the reasonably possible changes to those assumptions, and the key assumptions that would reduce value in use to the level of the carrying value.

Where indications of impairment lead to impairment test for the purposes of the interim accounts, the information above should be provided. The fact that the interim accounts are condensed financial statements in accordance with IAS 34 does not exempt preparers from providing full disclosure concerning impairment tests.

Finally, it must not be forgotten that the impairment of goodwill recognised in the interim accounts cannot be reversed at the end of the following annual reporting period, even where there has been a significant improvement. However, other impairments affecting tangible or intangible fixed assets, whether or not depreciable, can be reversed when prospects improve.

2. State support under part-time working measures

As we noted in our previous supplement, given the wide range of governmental measures, the first challenge for entities receiving State support is to determine which IFRS applies. This is because the measures to date may include:

- a significant extension of tax and social contribution payment deadlines;
- direct taxation reliefs (corporation tax, etc.);
- State-guaranteed loans;
- the recognition of circumstances constituting force majeure, resulting in non-application of late penalties in the case of customer contracts with the State;
- the implementation of part-time working measures;
- 'sick leave' for reasons of childcare.

Therefore, a case-by-case analysis is necessary to determine which standard applies: IAS 20 on grants, IAS 19 on employee benefits, IFRS 15 on revenue recognition, IAS 12 on income taxes, etc.

In the case of part-time working measures, there has been some doubt as to whether to apply IAS 20 or IAS 19.

The application of IAS 20 is justified where an entity acts on its own account and receives direct State aid to pay the wages due under an employment contract. In practice, should the State check that the eligibility conditions are met, it is the entity that will have to repay any monies wrongly received. However, the application of IAS 19 is appropriate where the entity pays a replacement income to the employee on behalf of the State, which reimburses the monies paid. In other words, the business is acting here as an agent for the State, and does not receive the grants on its own account.

In practice, similar grants paid in in different countries may be classified differently. The conclusion depends on a legal analysis of the part-time working measures introduced in each country.

Whether IAS 20 or IAS 19 is applied, this should not have any impact on the obligating event for recognition of the support granted by the State. In both cases, this is taken to be the date on which compensated wages are recognised (provided, in the case of IAS 20, that there is reasonable assurance that the entity will comply with any conditions attached and that the grants will be received).

However, the presentation in the statement of profit or loss will depend on the standard applicable. If the assistance received is covered by IAS 19, it must be accounted for as a deduction from payroll expenses. If IAS 20 applies, assistance received from the State will be presented in line with the accounting policy previously adopted (where applicable) for other grants related to income. In practice, this amount can be presented in 'other income' or as a deduction from the payroll expenses.

If the grants received from the State are significant, appropriate disclosures must be provided in both cases.

3. Presentation of the statement of profit or loss

In the previous edition of this supplement, we mentioned the fact that some industrial and services companies affected by the COVID-19 crisis have expressed a wish to reflect these impacts separately on the face of the income statement.

Since the publication of our previous supplement, and as described in our European highlights above, ESMA has clarified that the use of alternative performance measures (for example, recurring operating profit, where this is presented in the statement of profit or loss and outside IFRS financial statements for the requirements of financial communication, this sub-total not being required by IAS 1) must be consistent over time. In particular, ESMA recommends a cautious approach where existing measures are adjusted or new measures introduced with the aim of describing the impact of COVID-19 on financial performance and cash flows. It must also be ensured that these new or adjusted measures present performance in a transparent and fair manner, and do not give a misleading message to the market.

That said, and for practical purposes during the current crisis, ESMA considers that the introduction of “COVID-19” alternative performance measures is very unlikely to be useful since:

- COVID-19 has a generalised impact on overall financial performance;
- identifying the impacts of COVID-19 in a measure does not provide reliable and useful information to the market, and may distort understanding of the performance and financial situation of the issuer.

ESMA therefore recommends the use of disclosures in the notes rather than the amendment of alternative performance measures/sub-totals in the income statement. These disclosures should take the form of:

- narrative information to explain observed and expected impacts of the pandemic on operations and performance, the degree of uncertainty and the measures taken; and
- information, where applicable, on the impact of the pandemic on the estimates and assumptions applied, in particular in relation to impairment tests.

Key points to remember

- Discussions are still ongoing concerning several accounting issues raised by the COVID-19 pandemic. The opinions below represent Mazars’ preliminary views.
- Impairment test of long-term assets:
  - For many enterprises, the COVID-19 epidemic has led to situations indicating that an impairment may exist, necessitating impairment test when establishing the 2020 interim accounts.
  - The current degree of uncertainty surrounding the prospects for business activity do not exempt preparers from conducting impairment tests. Uncertainties may be reflected either through multiple weighted scenarios, or by adjusting the discount rate.
  - The disclosures in the notes will be crucial. In particular, information should be provided on the key assumptions and the sensitivity tests.
- State support under part-time working measures:
  - These must be accounted for in application of IAS 20 on grants or IAS 19 on employee benefits, depending on whether the entity is acting on its own account or as the agent of the State.
- Presentation of the income statement:
  - ESMA’s update of the Q&As on its guidelines for the use of alternative performance measures, specifically addressing the impact of COVID-19, is an important contribution to be taken into account when considering what may or may not be possible in order to present the impacts of the crisis in the income statement and in financial communication more generally.
  - In practice, ESMA recommends the use of disclosures in the notes, in preference to the amendment of alternative performance measures/sub-totals in the income statement.

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