# In the Spotlight

## A Consumer Markets Industry Focus on Covid-19 accounting considerations

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### COVID-19: Top 5 Accounting Issues for Consumer Markets

**At a glance**

The COVID-19 outbreak has developed rapidly in 2020, with a significant number of infections. Measures taken to contain the virus have affected economic activity, which in turn has implications for financial reporting.

Measures to prevent transmission of the virus include limiting the movement of people, restricting flights and other travel, temporarily closing shops, restaurants, businesses and schools, and cancelling events. This will have an immediate impact on businesses such as tourism, transport, retail and entertainment. It will also begin to affect supply chains and the production of goods throughout the world and lower economic activity is likely to result in reduced demand for many goods and services.

COVID-19 will impact many areas of accounting and reporting for all industries, as outlined in our publication.

Many entities in the consumer markets sector have been significantly impacted by the outbreak in particular due to mandated closure of retail outlets and leisure activities and changes in consumer behaviour. In this Spotlight, we provide our insights into the top five issues that might impact the consumer markets sector. This includes:

- Leasing arrangements
- Revenue recognition
- Impairment of non-financial assets and onerous contracts
- Impairment of financial assets
- Going concern

While this Spotlight focuses on issues that are likely to be the most frequently encountered, many others are certain to arise. As the situation continues to evolve, so too will the consequential accounting issues. For these reasons, the following is not an exhaustive list of all relevant accounting considerations.

Management should carefully consider the impact on each line item in the financial statements for both interim and annual reporting purposes. The top 5 issues we expect to see impacting consumer market entities are:

## 1. Leasing arrangements

The closure of a number of retail outlets and leisure activities has left many entities unable to make property lease payments. As a result, many lessors and lessees have been renegotiating payment terms to include reliefs such as rent free periods and rent waivers.

*IASB optional exemption for Covid-19-Related Rent Concessions*

On 28 May 2020 the IASB issued amendments to IFRS 16 that provide lessees (but not lessors) with an optional exemption from assessing whether a rent concession that is a direct consequence of the COVID-19 pandemic is a lease modification. The exemption allows lessees to elect to account for rent concessions in the same way as they would if they were not lease modifications. In many cases, this will result in accounting for the concession as a variable lease payment. The practical expedient only applies to rent concessions occurring as a direct consequence of the COVID-19 pandemic and only if all of the following conditions are met:

a. 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;

b. any reduction in lease payments affects only payments due on or before 30 June 2021; and

c. there is no substantive change to other terms and conditions of the lease.

For further information, see In brief: IASB issues IFRS 16 COVID-19 rent concessions amendment..

*Accounting for rent concessions if IASB exemption is not applied*

If a lessee cannot apply the exemption or chooses not to apply the exemption, judgement may be needed to determine the appropriate accounting treatment for lease concessions that are made in the context of COVID-19. Depending on the facts and circumstances, the substance of the concession might be appropriately accounted for as (negative) variable lease payments, forgiveness of some of the lease payments, deferral of some of the lease payments, or a lease modification. See FAQ – How should lease concessions related to COVID-19 be accounted for? for additional guidance.

Some key considerations are as follows:

- Pre-existing clauses. Some lease contracts contain pre-existing force majeure or similar clauses. Where such a clause applies to COVID-19 and results in reduced payments, the substance might be appropriately accounted for as negative variable lease payments.
- Forgiveness of lease payments. A concession in the form of a forgiveness of some of the payments with no change in the scope of the lease might indicate that the lessor is unilaterally forgiving a part of the lease, rather than the parties agreeing to modify the lease contract. This might be appropriately accounted for by applying IFRS 9's derecognition requirements for financial liabilities resulting in derecognition of a portion of the lease liability and a corresponding gain in the income statement at the time the forgiveness occurs.
- Deferral of lease payments. Some concessions might be in the form of the lease payments being rescheduled rather than reduced such that, in nominal terms, the consideration for the lease has not changed. An entity might judge that, where such a deferral is proportionate, it is not a lease modification since there is no change in either the scope of the lease or the consideration for the lease.

If the substance of the concession is not accounted for using the methods set out above, the concession might need to be accounted for as a lease modification. A lessee accounts for a modification by adjusting the lease liability and the corresponding right of use asset based on a revised discount rate at the modification date. The outcome is that the impact of the relief is recognised in profit or loss over the remaining term of the lease in the form of lower depreciation expense and finance cost. Application of the modification guidance could create significant practical changes for entities, particularly when they have a large portfolio of leases, as each individual lease would need to be recalculated if it meets the modification criteria.

*Government relief*

In some jurisdictions, the government will provide support to lessors and/or lessees. In many cases, the lessor will be the party that receives the relief from the government and applies IAS 20. This would be the case, for example, when lessors have discretion over what proportion of the rebate is allocated to individual lessees, the timing of when it is transferred and the manner in which the rebate is passed on. In such cases, the lessee will apply the guidance described above. However, in some cases, the substance may indicate that it is the lessee that receives the grant, and the lessor merely acts as a facilitator. Judgement might be required and the lessee should consider whether the relief it has received is a government grant in the scope of IAS 20.

The guidance above relates to arrangements that meet the definition of a lease in accordance with IFRS 16. However, similar negotiations might arise in other financial liabilities such as mortgages. Borrowers should apply the guidance in IFRS 9 to determine the impact of the change in terms as discussed in the InDepth referenced above.

## 2. Revenue recognition

Revenue recognition for consumer markets entities can often seem straightforward as revenue is recognised when the goods are sold (or shipped) to the customer at a unit price. However, in many cases, the amount of revenue recognised is affected by estimates, in particular those related to variable consideration arising from, for example, rebates, price concessions and returns. IFRS 15 requires that an entity estimates variable consideration and incorporates that estimate in the transaction price only to the extent that it is highly probable that a significant revenue reversal will not occur.

Furthermore, the current situation might mean that entities will change the way they contract with customers. This could impact revenue recognition going forward.

*Rebates and discounts*

Consumer market entities often offer rebates or discounts to their customers based on the volume of purchases or type of customer. Specifically, a price protection arrangement is commonly used where a manufacturer or distributor pays compensation to the retailer for losses as a result of reduction in the market price to facilitate sales after a markdown.

IFRS 15 requires entities to reduce the transaction price, and therefore revenue, for estimated rebates and discounts when it recognises revenue on shipment of the goods. Entities generally estimate the reduction of revenue based on historical experience. However, the current situation might mean that historical information about volumes of purchases, amounts of inventory held by customers and other factors might not provide appropriate or adequate evidence to recognise or estimate revenue in the same manner.

*Right of return*

Consumer markets entities often grant their customers the right to return products. Revenue is only recognised for those goods that are not expected to be returned and an asset recognised for an entity’s right to recover products from a customer. The estimate of expected returns should be calculated in the same way as variable consideration.

Expectations about returns could change due to extensions to return periods, delayed returns as customers were unable to come into a store or customers revising their purchase decisions on high-value items. Judgments related to bill-and-hold transactions might also need to be revised if goods are less likely to be claimed by customers.

In addition, return assets might need to be tested for impairment and additional restocking costs might need to be incorporated (for example, checking returned products for quality and sanitized appropriately for resale).

*Breakage on customer loyalty schemes*

Contracts with customers might include options to purchase additional goods or services for free or at a discount. These options can come in many forms, for example, customer award credits (or points) and often represent a material right to the customer. An amount based on the relative standalone selling price of the material right (ie. the award credit) is deferred taking into account the likelihood that the option will be exercised. This is often estimated based on historical customer behaviour. However, this may no longer be an accurate reflection of future customer behaviour.

Furthermore, entities might be extending the periods in which entities might permit customers to exercise such options. Management should consider whether these extensions and other potential changes to loyalty schemes would be accounted for as modifications under IFRS 15.

*Probability of collecting revenue*

Manufacturers or wholesalers might sell to customers that have limited liquidity. Revenue is only recognised when it is 'probable' that the entity will collect the consideration to which it is entitled. The assessment of probability should reflect both the customer's ability and its intent to pay as amounts become due. An entity that expects to provide a price concession should assess the probability of collection for the amount that it expects to enforce (that is, the transaction price adjusted for estimated concessions).

Entities will not normally enter into a contract with a customer if there is significant credit risk without also having protection to ensure it can collect the consideration. Therefore, there are generally limited situations in which a contract would not meet the 'probable' threshold; however, economic conditions might mean that entities are more likely to take part in such arrangements, for example, at the request of the government or for public good.

*Channels to market*

Many consumer market entities have developed other channels to market, in particular, using online purchase options. New channels will often result in different shipping terms and might include partnering arrangements with delivery service providers etc. For new arrangements, management will need to consider whether the shipping terms introduce a separate performance obligation and determine when control of the goods transfer to the customer (that is, upon transfer to the carrier or upon delivery).

If a third-party carrier is used to deliver the products and shipping is a separate performance obligation, management will need to evaluate whether they are the principal or agent for the shipping services. If they are the agent, consideration allocated to the shipping service should be recognised on a net basis (that is, revenue will be the commission income).

*Disclosure of revenue categories or operating segments*

If an entity's online business increases, it might now comprise a significant portion of the entity's combined revenue. Management should consider if it has another category of revenue for its disaggregated revenue disclosure (IFRS 15.114) or a new operating segment that requires disclosure (IFRS 8.13) if there is discrete information that is regularly reviewed by the chief operating decision maker.

## 3. Impairment of non-financial assets and onerous contracts

A number of consumer market entities will have an increased risk of impairment as a result of having to temporarily cease operations or an immediate decline in demand or prices and profitability. IAS 36 requires that goodwill and indefinite lived intangible assets are tested for impairment at a minimum every year and other non-financial assets including property plant and equipment (PPE) and right of use assets whenever there is an indicator that those assets might be impaired.

The In depth describes a number of considerations for assessing impairment in the current environment. In particular, an expected cash flow approach (multiple probability-weighted scenarios) might be a better way to capture the increased risk and uncertainty when estimating a recoverable amount as opposed to a single predicted outcome. Further information is available in the FAQ - Uncertainties in cash flows and change in valuation technique for level 3 fair value measurement. Some particular considerations for consumer market entities include:

- Management will need to consider carefully the long term impact of the pandemic and in particular when, or if, consumer behaviour will return to current levels.
- Management might reflect on the fact that some products have not been purchased by shoppers, even when stockpiling and consider if these products will be produced / sold going forward.
- Businesses that have allocated online sales to stores for the purposes of impairment assessment may find it harder to justify or calculate this in the current situation.

An impairment assessment should reflect the conditions that existed at the balance sheet date. This might be a complex assessment. For more information, see the following FAQs:

- FAQ – Adjusting events affecting impairment calculations related to non-financial assets with a measurement basis other than fair value
- FAQ – Adjusting events affecting remeasurement/impairment calculations related to assets with a measurement basis of fair value

*Inventories*

It might be necessary to write-down inventories to net realisable value. These write-downs could be due to reduced movement in inventory, lower sales prices or inventory obsolescence arising from changes to expected sales volumes (for example, certain inventory held might be 'out of season' when the outlets reopen). Entities should assess the significance of any write-downs and whether they require disclosure in accordance with IAS 2 Inventories.

IAS 2 requires fixed production overheads to be capitalised into the cost of inventory based on normal production capacity. Reduced production might affect the extent to which overheads can be included in the cost of inventory and some of these overheads might need to be expensed.

Entities might face difficulty in confirming inventory balances due to a lack of access to sites or staff shortages at reporting date. Management might need to reassess inventory counting procedures and in particular consider mitigating controls if the inventory count procedures need to be adjusted.

*Property, plant and equipment*

The current situation might mean that property, plant and equipment is under-utilised or not utilised for a period or that capital projects are suspended. IAS 16 Property, plant and equipment requires that depreciation continues to be charged in the income statement while an asset is temporarily idle if the entity uses a straight-line depreciation method.

Directly attributable costs incurred can not be capitalised while the asset is standing idle (for example, an asset that can operate, but is not brought into use immediately). IAS 16 only permits directly attributable costs to be capitalised until the point at which the asset is 'capable of operating in the manner intended by management'. If an asset is purchased or constructed and IAS 23 Borrowing costs requires that the capitalisation of interest is suspended when development of a qualifying asset is suspended.

*Onerous contracts*

Management will need to assess whether a provision should be recognised in accordance with IAS 37 Provisions, contingent liabilities and contingent assets when a contract with a customer is onerous as a result of increased unavoidable costs. Unavoidable costs could be viewed as including the costs that an entity cannot avoid because it has the contract which might include an allocation of overhead costs. These overhead costs might increase as a result of discontinuing the production or sale of non-essential goods or services.

In addition, entities should be on the lookout for other contracts that have become onerous, such as non-cancellable supply or service contracts that the entity does not expect to be able to utilise as a result of the virus.

## 4. Impairment of receivables

IFRS 9 requires that entities use an expected credit loss model to measure impairment of most financial assets. The expected credit loss (ECL) model requires consideration of both historical and current information as well as reasonable and supportable forecasts of future conditions (including macroeconomic information).

Many consumer markets entities use the simplified model for trade receivables and measure the ECL for the lifetime expected credit losses. Macroeconomic factors could impact the measurement and result in increased credit losses due to the credit deterioration of the customers.

Management should consider the need to disclose the impact of COVID-19 on the impairment of receivables including the requirement to present the impairment (including reversals) arising from the ECL model on the face of the income statement. Disclosures should also describe how the impact of forward looking information has been incorporated into the ECL estimate and details of significant changes in assumptions made in the reporting period. The impairment assessment should reflect the conditions that existed at the balance sheet date.

For further information, see In the Spotlight - How corporate entities can apply the requirements of IFRS 9 expected credit losses (ECL) during the COVID-19 pandemic

## 5. Going concern

Management should consider the potential implications of COVID-19 and the measures taken to control it when assessing the entity's ability to continue as a going concern. An entity is no longer a going concern if management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. Events after the reporting date that indicate an entity is no longer a going concern are always adjusting events.

Assessing going concern in this environment can be difficult and many of the challenges and considerations discussed above around estimating cash flows for impairment are relevant, in particular using multiple scenarios as well as assessing the long term impact of the pandemic and when, or if, consumer behaviour will return to current levels. Material uncertainties that might cast significant doubt on an entity's ability to continue as a going concern should be disclosed in accordance with IAS 1.

**Conclusion**

COVID-19 has given rise to unprecedented challenges that have affected virtually every aspect of modern life. The economic implications of the virus will have a consequent impact on many aspects of accounting and financial reporting. Therefore, transparent and comprehensive disclosures are key to helping entities to address the accounting challenges.