ACCOUNTING FOR COVID-19

ACCOUNTING STANDARDS BOARD

Accounting implications of the COVID-19 crisis

A nationwide lockdown came into effect from 27 March as a result of the COVID-19 crisis. The effect of the lockdown and the ongoing crisis means that the economy will experience a significant downturn, while there will be an increased need for government services and assistance. Areas that could be affected as a result of the crisis include the following:

- Construction, maintenance and related activities may be curtailed depending on whether they are essential. This could impact the completion of entities' capital projects and planned maintenance.
- Public facilities may not be operational and certain services may not be provided as a result of the lockdown (and beyond). This could impact the revenue of entities as well as the ongoing demand for services.
- There may be an increased demand for government:
    - Services such as medical services, the provision of water and other sanitation services, and the provision of temporary housing or accommodation.
    - Assistance and support to employees, unemployed citizens, businesses, NGOs, etc. due to the reduced activity in the economy.
- As some consumers of goods and services, taxpayers and other may be unable to work or earn revenue during the lockdown period, there is a potential increase in the non-payment for services such as water, electricity, property taxes, levies, etc. that are due to government entities.

While it is impossible to provide accounting guidance for all the implications related to the COVID-19 crisis, this document outlines the high-level issues that entities that apply Standards of GRAP should consider in preparing their financial statements for the 2019/20 reporting period.

Fundamental presentation principles

There are a few basic principles that entities should review regarding the preparation and presentation of information in the financial statements. These are outlined below.

Review accounting policies

Entities will need to review all their accounting policies to determine whether they are still appropriate. Attention should be given to the classification of assets and liabilities, the valuation methodology that is applied, and the inputs used in the valuation methodology. Any changes should be accounted for using GRAP 3 on *Accounting Policies, Changes in Accounting Estimates and Errors*.

Consider how information is presented in the financial statements

The presentation applied in the financial statements should be reviewed. Some potential issues to consider include the following:

- Where an item or class of item is material, separate presentation and disclosure in the financial statements is appropriate. Items affected by the COVID-19 crisis may warrant separate presentation or disclosure in the financial statements if they are considered material, either quantitatively or qualitatively. Refer to the Guideline on *The Application of Materiality to Financial Statements*.

- The current / non-current classification of assets and liabilities may need to be reconsidered. The classification of assets and liabilities is based on whether they will be recovered or settled no more than twelve months after the reporting date (current) or after more than twelve months after the reporting date (non-current). As an example: An entity has defaulted on a loan before the reporting date such that the loan is repayable on demand. If the entity does not have an unconditional right to defer settlement of the loan for at least twelve months after reporting date, then the loan is classified as a current rather than a non-current liability.

Enhance disclosures in the financial statements

Entities are required to provide information on estimation uncertainty in the financial statements. This is an area where entities have historically provided either no, or poor, information. Given the uncertain environment within which entities will be preparing their financial statements, there is an increased need to provide this type of information to users of the financial statements. Entities should provide information about:

(a) Key assumptions concerning the future, for example, those assumptions used in discounted cash flow projects.

(b) Key sources of estimation uncertainty at the reporting date. Where there is a significant risk that there will be a material adjustment to the carrying value of assets and liabilities in the next reporting period as a result of uncertainty in the valuation of assets and liabilities at the reporting date, entities should provide information about:

  - The assets and liabilities that are affected.
  - The carrying amounts of those assets and liabilities at the reporting date.

  Paragraphs .135 to .142 of GRAP 1 on *Presentation of Financial Statements* provides guidance on the type of information that entities should disclose.

Where entities have had to make specific assessments regarding the effect of COVID-19 and going concern, it may be appropriate for entities to disclose information about assumptions applied and uncertainty that exists.

As a reminder, entities should include all information in the financial statements that is relevant to the users of the financial statements. This could include information that is not specifically required by a Standard of GRAP.

Think about legislative reporting requirements

The legislation governing entities may require the separate reporting of information when certain circumstances occurred during the reporting period, for example, the disclosure of losses that have been incurred during a reporting period. Entities should apply these reporting requirements in addition to those required in the Standards of GRAP.

For example, if an entity incurs losses as a result of travel that was cancelled as a result of the lockdown, the travel expenses will be classified according to the requirements of GRAP 1, i.e. classification by nature or function, with separate disclosure of information in the notes to the financial statements on the losses incurred.

Key components of the financial statements

Revenue

Impact on the amount of revenue recognised

Consumers of goods and services, taxpayers and others may have difficulty in settling their debts. This is a reminder that entities should apply IGRAP 1 on *Applying the Probability Test on Initial Recognition of Revenue* when recognising exchange and non-exchange revenue. This means that entities should recognise the full amount of exchange and non-exchange revenue at the transaction date as they are accountable to collect revenue due. Non-collection of amounts due to entities, either based on history or on anticipated events such as the economic downturn due to COVID-19, is a subsequent measurement issue that affects the impairment of receivables. See the section below on "Assets".

Entities that are contractors would need to assess whether there is any effect on what are considered contract costs, and any related impact on the recognition of contract revenue. GRAP 11 on *Construction Contracts* provides guidance on the determination and recognition of contract costs and revenue.

Impact of financial support on revenue

The government has announced a range of support measures, some of which affect the tax to be collected. Consideration should be given to the following:

- Delayed payment of taxes. Entities should consider whether the delayed payment of taxes has an impact on the impairment losses recognised at year end.
- The provision of subsidies. Where tax subsidies will be provided as a form of economic relief, these should be treated as tax expenses. Tax expenses are foregone revenue in GRAP 23 on *Revenue from Non-exchange Transactions (Taxes and Transfers).* Consideration should however be given to whether the relief provided is a tax expense, or an expenditure paid through the tax system. GRAP 23 provides guidance on this distinction.

Entities should continue to monitor the relief programmes offered by the government and whether these programmes affect the amount of revenue entities recognise, or whether direct financial assistance such as loans are being provided (see the section on "monetary assets").

Expenses

Increased expenses on government programmes

A consequence of the increased need for government services and government assistance is the potential for increased expenses. The key consideration in accounting for the increased services and assistance is whether an obligation exists. Government may make promises and commitments to undertake certain activities or provide support, but until there is a clear past event that has occurred (through a contract, legislation or past practice) which means that there is no realistic alternative but to settle the obligation, there is no liability and no related expense. See the section below on "Liabilities".

The opposite may also be true – entities may need to reduce government spending in certain areas. See the section below on "Assets" and "Other issues".

Statutory disclosures

As governments are held accountable for their spending, there are often specific legislative reporting requirements related to the expenditure that entities incur. Entities should familiarise themselves with any specific reporting requirements that may exist. Entities should. Among others, consult the National Treasury's website.

Assets

Non-monetary assets

Non-monetary assets include inventories, investment properties, items of property, plant and equipment, intangible assets, biological assets or agricultural produce, and heritage assets.

The impact of the COVID-19 crisis is most likely to affect the valuation of non-monetary assets at reporting date. As most non-monetary assets are measured either at cost less impairment and/or accumulated depreciation or using a revaluation model or fair value, the potential implications on their valuation are as follows:

Depreciation

Where depreciation is recognised, entities should assess whether there is any indication that there has been a change in the useful life of assets (including the residual value where one exists). The following are examples that may indicate that there has been a change in the expected useful life:

- Changes in the use of an asset, e.g. how the asset is used, the utilisation rate of the asset, whether an asset was idle or retired from use during a period.
- Delays in repairing, maintaining or refurbishing assets.
- Changes in the condition of the asset.

Valuation at reporting date

Depending on the accounting policies an entity adopts, it may measure assets using current prices at reporting date.

(a) Fair value model (investment property):

- Entities should determine fair value at the reporting date. This means that the market conditions that exist on reporting date should be included in the asset's valuation. Where there has been a decline in the market conditions, these are reflected in a reduced market price and related fair value at the reporting date.
- Changes are recognised in surplus or deficit.
- It is important to provide users of the financial statements with information about the assumptions used in determining fair value.
- Given the changes in the market, it may be necessary for an entity to change the valuation methodology applied. For example, the best evidence of fair value is an observable price in a market of a similar asset (in the same location and condition). If no such information is available, an entity may need to use, for example, the price of an asset that is dissimilar and the price adjusted to reflect those differences, or to use a discounted cash flow projection. A change in an input into the valuation methodology is a change in estimate rather than a change in accounting policy.

Similar considerations are applied for measuring biological assets and agricultural produce within the scope of GRAP 27 on *Agriculture* at fair value less costs to sell.

(b) Revaluation model (property, plant and equipment, intangible assets, and heritage assets): Entities should determine fair value regularly enough so as to ensure that the carrying value of the assets are not materially different from the value that would have been recognised if fair value was used at reporting date. The same principles apply as for the fair value model, except that depreciated replacement cost can be used as a valuation method for specialised assets. The recognition of changes in fair value are recognised in the statement of changes in net assets (until the reserve has been utilised, and thereafter changes are recognised in surplus or deficit).

Impairment

The requirements of GRAP 21 on *Impairment of Non-cash-generating Assets* or GRAP 26 on *Impairment of Cash-generating Assets* should be applied.

Entities should assess whether there is any indication that an impairment loss should be recognised (or reversed). Based on the COVID-19 crisis, it may be important for entities to consider if, for example:

- There is evidence of physical damage or obsolescence of an asset.
- There are significant long-term changes that have occurred, or are expected to occur, in the way or extent to which an asset is used.
- There has been a decision to halt the construction or development of an asset before it is complete or in a usable condition.

An entity may need to develop its own indicators in addition to those in GRAP 21 and GRAP 26 in response to the COVID-19 crisis. These should be disclosed in the financial statements.

It is important to note that entities are required, on the initial recognition of an asset, to designate if it is cash or non-cash-generating. During times of economic distress, it may be that cash-generating assets are not generating a commercial return. It is important to note that the initial designation as cash or non-cash-generating is not changed unless the entity's objective for holding an asset has changed since initial recognition.

As with the valuation of assets, it is important for entities to provide relevant information to the users of the financial assets where impairments of assets (or write-downs for inventories) have occurred.

Other issues to consider

Where an entity adopts a policy of capitalising borrowing costs, it should consider whether the capitalisation of borrowing costs should be suspended. Borrowing costs should be suspended during extended periods during which the development of an asset is interrupted (Note: this is for interruptions that were not anticipated in getting the asset ready for use). During the time that borrowing costs are suspended, they are expensed rather than capitalised.

Entities should review all the information disclosed for non-monetary assets to ascertain if existing disclosures need to be modified, or new information provided. As an example, entities may need to consider whether the disclosures on work-in-progress are applicable, particularly when there is property, plant and equipment, investment property or heritage assets that are taking a significantly longer period of time to complete than expected, or where construction or development has ceased.

Considerations for inventory

Inventories are recognised initially at their cost. Cost could be based on the amount paid to acquire the inventories, or the amounts entities pay to produce or manufacture them. GRAP 12 on *Inventories* indicates which expenses are eligible to form part of the cost of the inventories. During the COVID-19 crisis entities should exclude costs associated with a low production, idle plant, or abnormal amounts of wastage.

Inventories are measured at the lower of cost and net realisable value or current replacement cost, depending on why the inventories are held.

Where net realisable value is applied, entities should consider whether there has been a decline in the selling price of inventories or an increase in the costs to make a sale. The selling prices are considered in the context of specific contracts that are in place or general selling prices that exist at reporting date (depending on the inventory's intended purpose).

Where current replacement cost is applied, entities should determine the amount that they would need to pay to acquire the economic benefits or service potential.

Monetary assets

Monetary assets include financial assets in the scope of GRAP 104 on *Financial Instruments* (2009), lease receivables in the scope of GRAP 13 on *Leases,* plan assets in the scope of GRAP 25 on *Employee Benefits,* and statutory receivables in GRAP 108 on *Statutory Receivables.*

Valuation at reporting date

As with non-monetary assets, a key consideration for entities will be the valuation at reporting date. Depending on the assets and the measurement basis in the relevant Standard, entities should consider the relevant conditions that exist at the reporting date in determining the fair value of assets, as well as considering whether the valuation methodology (also known as a valuation technique) applied is appropriate in the current environment.

A key consideration for assets that are measured:

- at amortised cost, for example, receivables, loans receivable, investments, lease receivables;
- at cost, for example, investments in equity instruments where no reliable measure of fair value is available; or
- using the cost method, i.e. statutory receivables;

is whether there is any indication that an impairment loss has been incurred on these assets. Due to the economic impact of the COVID-19 crisis on consumers, taxpayers and businesses, there is a high likelihood that there is observable evidence of an impairment loss, for example, default on the payment terms agreed, or financial difficulty of the counterparty.

Impairment losses are determined by comparing the carrying value of the asset to the amount determined based on the cash flows that an entity expects to collect, and when an entity expects to collect them. Even if an entity expects to receive all the cash flows but over a delayed period, an impairment loss has occurred. For financial assets, the cash flows are discounted using the effective interest rate of the asset. Paragraphs AG113-AG114 and AG120 in GRAP 104 provide guidance on the effective interest rate. For statutory receivables, when the time value of money is material, the cash flows are discounted using a risk-free rate, adjusted for any specific risks relevant to the receivable. If investments in residual interests are measured at cost, an entity uses the market rate at reporting date to discount any cash flows.

Impairment losses are recognised in surplus or deficit, and either reduce an individual debtor's account directly or are recognised in a "loss allowance". See the section below on "Other issues".

Enhanced disclosure about how impairment losses have been identified and determined will be important to the users of the financial statements.

Entities should also consider whether there have been any modifications (including renegotiations) to the arrangements that would affect either the recognition or measurement of the existing assets at reporting date. The requirements for "modifications" or similar in the applicable Standard should be consulted. Breaches and terminations may affect the classification of instruments, see the section on "Fundamental presentation principles".

Other issues

Concessionary loans granted as part of a government relief programme

Entities may be involved in providing financial support to individuals, businesses and others. Where this is done through loans that are granted on favourable terms, for example, loans with payment holidays or low or no interest loans, entities should apply the requirements in GRAP 104 on concessionary loans. For concessionary loans, entities will be required to determine the fair value of an equivalent loan in the market and recognise any difference between the amount granted on initial recognition and the fair value as a social benefit in accordance with the *Framework for the Preparation and Presentation of Financial Statements*.

Considerations for collateral held for loans granted

Entities frequently provide loans to small businesses, farmers, etc. and others who would not otherwise qualify for financing. Many of these loans are granted with the underlying business being provided as collateral for the debts owing. In the event of default, the lender – which might be a public sector entity – may acquire a controlling (or other) interest in the underlying equity of the business. Where this is the case, an entity should consider whether a controlling interest has been acquired such that consolidation is necessary. Other relationships such as the existence of significant influence or joint control should also be considered. Refer to the Standards of GRAP on *Consolidated and Separate Financial Statements*, GRAP 7 on *Investments in Associates* and GRAP 8 on *Interests in Joint Ventures*.

Treatment of financial guarantees held by an entity

Public sector entities may themselves receive financial support from another level of government or from its parent entity. This financial support could take the form of financial or other guarantees. Financial or other guarantees held by an entity are not recognised as assets.

Liabilities

As noted in the section on "Expenses", a key consideration in accounting for the various government activities and programmes announced to respond to the COVID-19 crisis, is whether a liability exists.

Liabilities could be financial liabilities in the scope of GRAP 104, lease liabilities in GRAP 13, accruals and provisions in GRAP 19 on *Provisions, Contingent Liabilities and Contingent Assets*, and liabilities related to employee benefits in GRAP 25. The following distinction is important:

- Financial liabilities are contractual arrangements where the entity has an unconditional obligation to settle a liability with another party in cash or another financial liability. A lease liability is a type of financial instrument but accounted for using GRAP 104 and not GRAP 13.
- Provisions are liabilities of uncertain timing and amount, and could be legal obligations which arise from contracts, legislation, or common law, constructive obligations that arise from past practice.
- Any benefits provided by an employer to an employee are "employee benefits".

Given the broad ranging support promised by government during the COVID-19 crisis, it is difficult to comprehensively address all scenarios that could exist within the categories defined above. Entities should therefore understand what promises, commitments, or obligations they, or another level government, have made to determine whether a liability exists at the reporting date, whether an existing liability should be modified, or whether disclosure is needed in the notes to the financial statements.

Some important issues to note that may be relevant during the COVID-19 crisis:

- Financial liabilities: Where an entity owes money to another entity, for example, as a payable, or loan owing to another entity, the other party may provide the entity with modified repayment terms. Where the terms are substantially modified, an entity should consider derecognising the old instrument and recognising a new financial liability. A substantial modification of a financial liability is when the discounted present value of the cash flows under the new terms, discounted using the effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability.
- Financial or other guarantees issued by an entity: Where an entity guarantees the debt of another entity or provides a performance or other guarantee to another party, the requirements of GRAP 19 are applied.
- No specific guidance is provided in GRAP 19 on social benefits. Entities can apply GRAP 19 to account for social benefits. Clear, specific information should be disclosed in the financial statements about the past event that gives rise to these obligations and any judgements or uncertainty that exist in measuring these obligations.

Entities should consider whether any onerous contracts, i.e. those contracts where the unavoidable costs of meeting the obligations in the contract exceed the economic benefits or social benefits that will be received, have arisen as result of the COVID-19 crisis. It is important to note that onerous contracts do not include those that arise from the provision of social benefits.

Other issues

Events after the reporting date

A key issue that entities will need to consider is how to deal with events that occur after the reporting date in GRAP 14 on *Events After the Reporting Date.*

Entities will adjust the amounts recognised or disclosed in the financial statements for events that provide evidence of conditions that existed at the reporting date, for example, the subsequent bankruptcy of a debtor where an impairment loss was included in the loss allowance recognised at reporting date, may affect the measurement of the impairment loss.

Entities will not adjust the financial statements for events that arise after the reporting date, for example, the announcement of additional financial assistance to be provided by government after the reporting date. The following information is disclosed in the financial statements about events that occur after the reporting date:

- The nature of the event.
- An estimate of the financial effect, or statement that the effect cannot be determined.

Presentation of budget and actual information

Entities are required to present information that compares actual and budget information in the financial statements. The comparison uses the final approved budget. This means that an entity should present any adjustments such as transfers, appropriations, allocations, between the last approved budget and the final budget in the comparison. This may be particularly relevant where entities have had to re-allocate resources or appropriate additional resources to deal with the COVID-19 crisis.

Risk disclosures

Entities are required in GRAP 104 to provide information on credit risk, liquidity risk, and where relevant to users of the financial statements, exposure to market risk. Given the economic environment, these disclosures are particularly important to users of the financial statements as they provide predictive information about the financial health of entities.

This document has been prepared by the Secretariat of the ASB. This document outlines high-level considerations that entities should consider. It is not a substitute for a complete review of the relevant Standards and application of their principles.