Educational material 3

APPLICATION OF IFRS STANDARDS IN LIGHT OF THE CORONAVIRUS DISEASE (COVID-19) UNCERTAINTY

Disclosure of judgements and sources of estimation uncertainty

Issued April 2020

Contents

Disclaimer
Please note that every effort has been made to ensure that the advice given in this educational material is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.

1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, highlighting the requirements within IFRS and areas of best practice that are relevant for entities considering how the pandemic affects their accounting for financial periods ending on or after 31 December 2019.

Entities are reminded to consider the impact of events related to COVID-19 on both interim and annual financial statements. Whilst this educational material highlights examples usually considered in the annual financial statements – given the significance of uncertainties that may be created by the COVID-19 epidemic - entities should consider similar disclosures in the interim financial statements where relevant.

This guidance does not change, remove nor add to, the requirements in IFRS. It is intended to support the sound, consistent and robust application of requirements in IFRS. It is of importance that IFRS is applied consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

2. Purpose of the educational material

This educational material summarises the requirements of IAS 1 (in paragraph 3 below) and seeks to identify best practice questions that may be considered when contemplating disclosures about judgements and sources of estimation uncertainty under IAS 1 (see paragraph 4 below). It goes on to illustrate how those questions may be applied to a disclosure example in order to provide meaningful and entity specific disclosures (see paragraph 5 below).

3. Disclosure of judgements and sources of estimation uncertainty – Application of IAS 1

The COVID-19 pandemic is affecting major economic and financial markets. Virtually all industries are facing challenges associated with the economic conditions resulting from efforts to address it.

As the pandemic ensues globally and locally, entities are experiencing a cross-functional impact on their business relating to financial reporting, operational concerns and supply chain management. The continuation of these circumstances could result in an even broader economic downturn that could have a prolonged negative impact on an entity's financial results.

As a result of the uncertainty associated with the unprecedented nature of the COVID-19 pandemic, entities are likely to face difficulties related to selecting appropriate assumptions and developing reliable estimates to determine their related impact when preparing financial statements.

In developing estimates and applying their judgement made in selecting appropriate assumptions, management will need to consider all available information including whether they have met all applicable disclosure requirements - including those in IAS 1. Information about how management arrived at key judgements and estimates and why those assumptions and methods were used are crucial during this period of uncertainty as it will provide insight to investors and other relevant stakeholders in understanding management's rationale when preparing the financial statements.

There are two distinct requirements in IAS 1 relating to disclosure of the judgements and estimates made by management that have the most significant effect on the amounts recognised in the financial statements:

- Judgements in applying accounting policies - IAS 1.122 requires disclosure of the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements. In SAICA APC's view, facts and circumstances need to be considered and taken into account when assessing the extent and balance between both qualitative (narrative) and quantitative judgemental disclosures to achieve compliance with IAS 1.122.
- Assumptions and sources of estimation uncertainty - IAS 1.125 requires disclosure of information about the assumptions the entity makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Due to the inherent uncertainty caused by the pandemic on global and domestic financial markets, these disclosures should be considered carefully by management as a tool for providing transparent and useful information to users of financial statements. IAS 1.129 states that these disclosures should be presented in a way that helps users of the financial statements to understand the judgements management makes about the future and about other sources of estimation uncertainty. The nature and extent of the information to be disclosed will vary according to the nature of the assumptions and the other circumstances. IAS 1.129 gives the following examples of the types of disclosures to be made:

a) the nature of the assumption or other estimation uncertainty;
b) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;

c) the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and

d) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

IAS 1.131 acknowledges that it may be impracticable to disclose the extent of the possible effects of an assumption or another source of estimation uncertainty at the end of the reporting period. In such cases, IAS 1 requires the entity to disclose that it is reasonably possible, based on existing knowledge, that outcomes within the next financial year that are different from assumptions could require a material adjustment to the carrying amount of the affected asset or liability. In these circumstances management should consider all facts and uncertainties and assess what would provide useful, relevant and reliable disclosure to understand the facts and uncertainties. This could include a probability weighted outcome as a result of the estimation uncertainty that exists.

Impact of disclosure requirements of other IFRS standards and requirements of IAS 1

Compliance with specific disclosure requirements of other standards may not be sufficient to meet IAS 1's requirements. For example,

- It is possible that impairment testing of property, plant and equipment could involve assumptions that fall within the scope of IAS 1.125. In such cases, sensitivity disclosures may need to be provided to meet IAS 1's requirements even though they are not always explicitly required for impairment tests of such assets by IAS 36 *Impairment of Assets* (IAS 1.126).
- In other instances the disclosure requirements (of say IFRS 13 – *Fair Value Measurement*) may already cover some of the requirements of IAS 1.125. In those instances it is necessary to determine whether any additional information is required to be disclosed (over and above the IFRS 13 requirements) to fully comply with IAS 1.125.
- Furthermore IAS 1.17 states that, in virtually all circumstances, an entity achieves fair presentation by compliance with applicable IFRS. However, fair presentation also requires an entity to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (IAS 1.17(c)). This may be particularly relevant in the current circumstances as users seek to understand the impact of COVID-19 on the reporting entity.

4.   Application considerations for effective IAS 1 disclosures

In SAICA APC's view management should apply the following questions against proposed IAS 1 disclosures in the AFS to test whether the proposed disclosures are entity specific, transparent and achieve best practice:

Judgements in applying accounting policies (IAS 1.122)

Does the proposed disclosure:

- Identify the alternatives that management considered (e.g. option (a) vs option (b));

- Explain why the choice was difficult/ judgemental; and

- Provide a fact specific (entity specific) explanations as to why option (a) was chosen over option (b)?

Assumptions and sources of estimation uncertainty (IAS 1.125)

Does the proposed disclosure:

- Identify what the different assumptions (or variabilities within an assumption) are (i.e. what facts/ variables/ alternatives did you consider in your measurement);

- Prioritise quantifiable disclosures above qualitative information (if possible);

- Explain the sensitivity of the outcome to changes in the methods, assumptions and estimates used in the calculation; and

- Identify the view that management thought was most likely (or that management applied a probability based outcome) when measuring the item?

Consistency and specificity

As this pandemic has wide reaching consequences across all areas of the financial statements, a number of assumptions or estimates may be required for more than one purpose (e.g. forecast revenues may be relevant to impairment tests, forward looking information for expected credit loss measurement and recognition of deferred tax assets). SAICA APC recommends that, to the best of their ability, management use

consistent assumptions when making these assessments and ensure the disclosure is specific to the facts and circumstances of the entity.

5.   Disclosure examples

The questions identified in paragraph 4 above have been applied to a hypothetical example of estimation uncertainty to illustrate the types of disclosures that may be impacted by IAS 1. For ease of reference the icons identified in paragraph 4 have been applied to identify the questions considered in the disclosure examples.

Disclosure example – Best practice example disclosure of assumptions and sources of estimation uncertainty on current reported balances (IAS 1.125):
(Also see IAS 10 education material which illustrates COVID-19 conditions existed at 31 March 2020, and events occurring subsequently are adjusting events)

The example provides simplified disclosure for a portfolio of investment properties. Properties of different grades and in different geographical locations may result in more variables needing to be considered in the fair value determination and disclosure thereof. In other instances the extent of disclosure may depend on the extent of the estimation uncertainty in the context of the reporting entity.

Note 4: Investment property

The Group's investment property comprises shopping malls in Gauteng, the Free State and Western Cape which are held by the Group to earn rental income. The majority of lettable area is occupied by retail tenants, however some malls also let space in the office sector. The valuation of shopping malls is determined with reference to an external valuation. Significant judgement is required when evaluating the inputs into the fair value determination and hence this is seen as critical to the estimation uncertainty. Management views the sector profile (retail vs office) as having a more pronounced impact on the fair value inputs than the geographical location of the shopping malls.

The recent outbreak of COVID-19 has significantly affected the South African economy and our industry. The uncertain economic outlook for the period of (and post) the lockdown may result in a decrease in mall traffic, reduce the number of hours shopping malls remain open or force us to cease operations entirely. The virus is expected to have a material adverse effect on our tenants' operations; the viability of their business and their ability to meet their rental obligations. This uncertainty is factored into the valuation of our investment property, specifically in the discount rate, exit capitalisation rate, growth rates, vacancy periods and rent-free periods, all of which are significant inputs into the fair value determination.

Measures put in place by Government as it relates to the lockdown resulted in the Group providing relief to 70% of our tenants (weighted based on contractual rental

income) in the form of rent free periods during the lock down which has also impacted the valuations of our investment property.

The assumptions that have the most significant impact on the valuations are listed below. The impact of COVID-19 to these assumptions for the current year is specifically quantified[#]:

- Discount rates:
  - Increased by 100 basis points (retail) and 85 basis points (office) calculated on a probability weighted basis as a result of COVID-19;
  - The depressed state of the economy and an increase in borrowing constraints also contributed to the increased discount rate in the current year;
- Exit capitalisation rates:
  - Increased by 125 basis points (retail) and 75 basis points (office) calculated on a probability weighted basis as a result of COVID-19;
  - The subdued investor demand for retail property in key metropolitan areas also contributed to an increase in exit capitalisation rates;
- Expected market rental growth rates:
  - Decreased by 50 basis points for both retail and office calculated on a probability weighted basis as a result of COVID-19;
  - Other factors contributing to the decrease in expected market rental growth rates relates to the combined impact of falling medium-term inflation forecasts coupled with weaker occupier demand;
- Vacancy periods:
  - Increased by 4 months for both retail and office calculated on a probability weighted basis as a result of COVID-19;
  - Other factors contributing to the change in the vacancy periods were the depressed state of the economy and an increased competition for space as new malls were opened;
- The period of the rent free occupation during the lock down was based on actual rent-free periods granted.

(*# Note: The quantitative figures expressed in this example are illustrative only and should not be relied upon to represent actual results*)

A sensitivity analyses on these assumptions to evaluate the extent of impact on the fair value of our investment property is included further on in this note.

Reconciliation of investment property	31 March 2020 R 000's	31 March 2019 R 000's
Opening balance	1 700 000	1 500 000
Fair value adjustments	(300 000)	200 000
Closing balance	1 400 000	1 700 000

Independent valuers

The Group has employed the services of Mr. E Expert of Valuers Properties Consultants. Mr. E Expert is a professional valuer registered in accordance with section 20(2) (a) of the Property Valuers Professional Act 47 of 2000, is not connected to the Group and has recent experience in the location and category of the investment property being valued. He holds a Dip. Val. MIV (SA) qualification and his registration number is 123.

Valuation techniques

The investment property was valued as at 31 March 2020 using a discounted cash flow of future income streams methodology. All investments properties are considered Level 3 hierarchy in terms of IFRS 13.

The following unobservable inputs were used when estimating the fair value of the investment property:

Retail Unobservable input #	31 March 2020	31 March 2019
Discount rate	**12.50% - 15.50%**	11.25% - 14.00%
Exit capitalisation rate	**8.50% - 10.50%**	7.25% - 8.50%
Expense growth	**7.00%**	7.00%
Income growth	**3.00% - 5.50%**	4.00% - 6.00%
Vacancy periods	**0 – 24 months**	0 – 12 months
Rent-free periods	**0 – 6 months**	0 – 3 months

Office Unobservable input #	31 March 2020	31 March 2019
Discount rate	**12.50% - 14.50%**	11.50% - 13.00%
Exit capitalisation rate	**8.75% - 10.75%**	7.75% - 9.50%
Expense growth	**7.00%**	7.00%
Income growth	**3.00% - 5.50%**	4.00% - 6.00%
Vacancy periods	**0 – 24 months**	0 – 12 months
Rent-free periods	**0 – 12 months**	0 – 6 months

(# Note: The quantitative figures expressed in this example are illustrative only and should not be relied upon to represent actual results)

The estimated impact of a change in the following significant unobservable inputs would result in a change in the valuation as follows:

	Retail		Office	
Sensitivity analysis #	31 March 2020 R 000's	31 March 2019 R 000's	31 March 2020 R 000's	31 March 2019 R 000's
A decrease of 25 basis points in the discount rate	22 000	32 000	15 500	26 000
An increase of 25 basis points in the discount rate	(21 000)	(30 500)	(14 750)	(24 500)
A decrease of 25 basis points in the exit cap rate	19 500	28 750	17 500	24 000
An increase of 25 basis points in the exit cap rate	(18 500)	(27 500)	(16 750)	(23 000)
A decrease of 25 basis points in the income growth rate	(18 000)	(20 000)	(15 000)	(17 500)
An increase of 25 basis points in the income growth rate	20 000	22 000	17 500	20 000
A decrease of 3 months in the vacancy period	5 850	6 500	4 750	5 500
An increase of 3 months in the vacancy period	(5 500)	(6 100)	(4 500)	(5 250)
A decrease of 1 month in the rent free period	4 400	4 800	3 350	3 700
An increase of 1 month in the rent free period	(4 375)	(4 750)	(3 325)	(3 675)

(*# Note: The quantitative figures expressed in this example are illustrative only and should not be relied upon to represent actual results)*