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 coronavirus (COVID-19) pandemic has developed rapidly in 2020, with measures taken to contain the virus affecting 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: Accounting implications of the effects of coronavirus: PwC In depth INT2020-02

Many entities in the consumer markets sector have been significantly impacted by the pandemic, in particular due to the 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. These include:

- leasing arrangements;
- revenue recognition;
- impairment of non-financial assets and onerous contracts;
- impairment of receivables; and
- 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.

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

1. Leasing arrangements

On 17 April 2020, the IASB tentatively decided to propose amendments to IFRS 16 that would 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. This Spotlight does not take into account any amendments to IFRS 16 that might result from this decision. As at the date of this publication, these proposals have not been finalised, and the next milestone is the publication of an exposure draft. See IASB project page for further details.

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.

Accounting for such reliefs might be complex. On 10 April 2020, the IASB issued a document intended to support the consistent application of IFRS to lease concessions related to COVID-19 (see link). Judgement might 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, a 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 when 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.

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Application of the modification guidance could create significant practical challenges for entities, particularly where they have a large portfolio of leases, because each individual lease would need to be recalculated if it meets the modification criteria. As noted above, the IASB tentatively decided to propose amendments to IFRS 16 that would 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. This Spotlight does not take into account any amendments to IFRS 16 that might result from this decision.

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 respect of 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 In depth referenced above.

2. Revenue recognition

Revenue recognition for consumer market entities can often seem straightforward, because 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 an entity to estimate variable consideration and to incorporate 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 in which 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 market 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 is recognised for

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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 (since customers were unable to come into a store), or customers revising their purchase decisions on high-value items. Judgements 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 that they have been sanitised 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 they often represent a material right to the customer. An amount based on the relative stand-alone selling price of the material right (that is, 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 might no longer be an accurate reflection of future customer behaviour.

Furthermore, entities might be extending the periods in which they 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 intention 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).

An entity will not normally enter into a contract with a customer if there is significant credit risk without also having protection to ensure that 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 the 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 they will need to determine when control of the goods transfers to the customer (that is, on transfer to the carrier or on 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

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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 (para 114 of IFRS 15) or a new operating segment that requires disclosure (para 13 of IFRS 8) 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 in prices and profitability. IAS 36 requires goodwill and indefinite-lived intangible assets to be 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 here. 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 previous levels.
- Management might reflect on the fact that some products have not been purchased by shoppers, even when stockpiling, and it might consider whether these products will be produced and/or sold going forward.
- Businesses that have allocated online sales to stores for the purposes of impairment assessment might 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'.

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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 the reporting date. Management might need to reassess inventory-counting procedures and, in particular, consider mitigating controls if the inventory-counting procedures need to be adjusted.

Property, plant and equipment

The current situation might mean that PPE is under-utilised or not utilised for a period, or that capital projects are suspended. IAS 16, ‘Property, plant and equipment’, requires depreciation to continue 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 cannot 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, IAS 23, ‘Borrowing costs’, requires the capitalisation of interest to be 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’, where 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 a 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 entities to use an expected credit loss (ECL) model to measure impairment of most financial assets. The 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 market 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 give 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.

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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 that 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 previous 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 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.

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