COVID-19: ACCOUNTING IMPLICATIONS IN BOTH 2019 & 2020 FINANCIAL STATEMENTS
MEXICAN FINANCIAL REPORTING STANDARDS

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Introduction

The global economy in the 21st century already faced an important crisis in 2008. On that occasion, the crisis stemmed in the real estate industry in the USA and, subsequently, affected the international financial markets, situation that questioned the validity of the financial reporting standards issued by the main standard-setting bodies.

To deal with this crisis regarding financial reporting standards, the G-20 requested those bodies in charge of issuing the international standards, the issuing of accounting standards that would allow entities to recognize in their financial information the economic aspects resulting from the crisis.

In that same year, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) of the United States, took on the commitment of improving confidence in the financial information prepared for the capital markets and steer efforts for maintaining high-quality accounting standards besides accelerating regulatory convergence at the international level. Therefore, the normativity was issued at a global level for the recognition of the economic effects affecting corporations, not only by considering historic and current information as had been done traditionally, but also taking into consideration the forecasted information.

Facing the current situation that the global economy is facing due to the COVID-19 pandemic, declared by the World Health Organization on March 1, 2020, and the heath emergency published by the Mexican Government on March 30, 2020 in the Official Gazette, the question arises as to whether the current accounting normativity at the international and Mexican level, will allow corporations to recognize the effects, which in their financial information could have the current and future situation of the COVID-19 pandemic.

The response is, in this case, favorable. Both the International Financial Reporting Standards (IFRS) and Mexican Financial Reporting Standards (NIF for the acronym in Spanish), provide the measuring, presentation and disclosure that corporations would have to undertake in their 2019 and 2020 financial statements to recognize and disclose the possible COVID-19 pandemic.

The effects of the pandemic in the economic activity in Mexico are already occurring and are affecting the various aspects of business entities. In some industry sectors, due to their operations, the effects are taking place immediately, such as tourism, manufacturing, financial, entertainment, health, just to name a few, while for other industry sectors, the effects will be imminent, situations that are and will be also affecting the financial information of corporations.

The analysis herein presented reflects the interaction of Mazars at an international and local level, mainly what is being commented by the issuers of accounting standards of the main world economies, regulators and those interested in financial information. Any change that may arise in the accounting profession at an international and local level, shall be updated and informed, since they are topics still being discussed within the accounting profession.

Mazars in Mexico
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March 2020

COVID-19: ACCOUNTING IMPLICATIONS AS AT 31 DECEMBER 2019 FOR BUSINESS ENTITIES

COVID-19: HOW TO QUALIFY THE OUTBREAK EVENTS FROM AN ACCOUNTING PERSPECTIVE

Consensus between audit firms & stock exchange regulators!

An entity <u>shall not adjust</u> the amounts recognized in its financial statements as at 31 December 2019 to reflect the events occurring after the reporting period that are caused by the COVID-19 outbreak…

NIF-B13
Paragraph 9:
«subsequent events requiring only disclosure»

… unless such events **call seriously into question the validity of the going concern assumption**
(see a little further in the presentation for assessment guidance)

NIF B-13
Paragraph 17

Consequently, the COVID-19 outbreak impact on financial statements at <u>31 December 2019</u> is limited to **disclosures only**
(see dedicated slide hereafter)

COVID-19: SOME QUESTIONINGS

Shall the business plans used for impairment tests at 2019 year-end be reviewed? **Bulletin C-15**	**No**, insofar as (i) these business plans shall be based on the existing situation as at 31 December 2019 and because (ii) at that date, there were no observable indications that the assets' value had declined due to events related to COVID-19 → **the cash flows forecasts shall therefore not take into account the effects of the outbreak**
Shall the fair value (level 3) of unlisted securities that are non-consolidated be discounted? **NIF B-17**	**No**, insofar as (i) the assessment of fair value is conducted at a determined date and because (ii) from a market participant perspective, the information related to COVID-19 were not available at 2019 year-end closing → **the fair value (level 3) of unlisted securities shall therefore not be reassessed because of the outbreak**
What are the impacts on the provisioning of expected credit losses? **NIF C-16**	The erosion in credit quality of customers due to the COVID-19 outbreak is caused by events that occurred in 2020 → **as a consequence, the impairment of trade receivables as at 31 December 2019 shall not integrate the effects of the outbreak**

COVID-19: HOW TO ASSESS THE GOING CONCERN ASSUMPTION (1/2)

1

How to assess in practice whether the going concern assumption is still appropriate?
NIF A-2, Basic postulates

EVENTS

- Consider events both before and after the reporting date, **up till the date of authorization for the issue of the financial statements**
- Do not consider the **accounting qualification of events** (i.e. irrespective of whether those events are adjusting or non-adjusting events according to NIF B-13)

FACTORS

Consider all the **existing and anticipated impacts** of the COVID-19 outbreak on the economic conditions of the entity, in view notably of the following factors:

- Significant decline in revenue
- Significant erosion of profits due to higher costs or incurring unforseen costs
- Breach of debt covenants
- Cash flow issues
- Expected impacts of announcements of government´s support to the economy

COVID-19: HOW TO ASSESS THE GOING CONCERN ASSUMPTION (2/2)

2

What are the accounting implications if the assessment brings to conclude that the validity of the going concern assumption is seriously undermined?

NIF A-6, Recognition and measurement

Under Mexican NIF
An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so ⇨ **The financial statements as at 31 December 2019 shall therefore be prepared from a business termination perspective (i.e. on the basis of net asset values)**

COVID-19: DISCLOSURES IN THE NOTES OF THE FINANCIAL STATEMENTS

Key principle: ensure the adequacy and the relevance of the information disclosed to assess the major sources of estimation uncertainty at the end of the reporting period

Objective: measure the risk of material adjustment to the carrying amounts of assets and liabilities, which must cover at least, but not be limited to, the following twelve months from the date of the statement of financial position (NIF B-13 Paragraph 8)

Under NIF (non-exhaustive list)

- Information about **non-adjusting events** after the reporting period (NIF B-13 Paragraph 18):
  - Nature of the event
  - Estimate of its financial effect (or a statement that such an estimate cannot be made)
- Information about the **assumptions** made for the future, and other **major sources of estimation uncertainty** at the end of the reporting period (see following)
- Information about **going concern** (NIF B-13 Paragraph 17):
  - ✓ The fact that the financial statements are not prepared on a going concern basis, or
  - ✓ The material uncertainties that may cast significant doubt upon the entity’s ability to continue as a going concern (but without questioning the relevance of the going concern assumption)

Expects issuers to provide both qualitative and quantitative information on the actual and potential impacts of the outbreak

COVID-19: ACCOUNTING IMPLICATIONS ON (ANNUAL OR INTERIM) 2020 CLOSINGS

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020

1. EVENTS THAT OCCURRED AFTER THE REPORTING PERIOD AND GOING CONCERN
2. INTERIM FINANCIAL INFORMATION AND AT THE END OF THE YEAR
3. MEASUREMENT OF NON-FINANCIAL ASSETS
   - Impairment tests
   - Measurement of inventories
   - Depreciation of assets
4. FINANCIAL INSTRUMENTS
   - Fair value measurement
   - Impairment of financial instruments receivable
   - Cash and cash equivalents
   - Financial liabilities
   - Cash management & liquidity risk
   - Factoring & securitization (off balance-sheet programs)
   - Hedge accounting
   - Disclosures on financial instruments
5. REVENUE RECOGNITION
6. PROVISIONS
   - Applying NIF C-9, *Provisions, contingencies and commitments*
   - Employee benefits and measures to reduce activity
7. INCOME TAX
8. PROFIT OR LOSS PRESENTATION
9. OTHER IMPLICATIONS
   - Insurance recoveries
   - Temporary decrease in lease payments
   - Capitalisation of borrowing costs
   - Foreign currency conversion
   - Government grants
10. DIFFERENCES VS. INTERNATIONAL FINANCIAL REPORTING STANDARDS

INFO

#COVID19

THE INFORMATION PRESENTED IN THIS SECTION REPRESENTS MAZARS' PRELIMINARY VIEWS. MOST SUBJECTS ARE STILL UNDER DISCUSSION WITHIN THE ACCOUNTING PROFESSION, WITH THE MEXICAN NATIONAL-STANDARD SETTER.
WE WILL KEEP YOU INFORMED ABOUT DEVELOPMENTS IN THESE DISCUSSIONS AND THE CONSEQUENCES ON THE CORRESPONDING TECHNICAL ANALYSES

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *EVENTS THAT OCCURRED AFTER THE REPORTING PERIOD AND GOING CONCERN*

Reminders of key dates

- **Public emergency health announced by the World Health Organization on 30 January 2020**
- Outbreak qualified as pandemic on 11 March 2020
- **Health emergency published by the Mexican Government on March 30, 2020 in the Official Gazette**
- Containment decisions taken at different times around the world
- Announcements of governments following the crisis, namely in view of the support to the economy, at different times, and measures have been specified progressively

Consequences

- Financial statements as at **31 December 2019**: **non-adjusting events**
- Financial statements as at **31 March 2020**: **adjusting events**
  - Information about the crisis' magnitude are known
  - Main principles of measures of support to the economy are announced
- Financial statements as at **31 January** or **29 February 2020**: **to be discussed**
  - Ongoing debate on the date until which information should "retroact"
  - Shall we consider several distinct events (the outbreak, the containment decisions – possibly by country, the support measures…)?
  - In particular for the financial statements as at 31 January 2020: what information were known? Could we anticipate the international expansion of the containment measures?

Going concern

- The assessment of the validity of the going concern assumption shall be done **up till the date of authorization for the issue of the NIF financial statements**
- Assumption shall be changed only if the going concern is **seriously compromised**

Reminder

Interim financial information

NIF B-9

- Financial information at intermediate dates is intended to provide timely, useful information so that the user can evaluate an entity:
  - ✓ its ability to generate profits and cash flows;
  - ✓ Its financial position and liquidity;
  - ✓ in its case, its ability to carry out your social benefit activities; among other issues

The policies for recognizing assets, liabilities, equity, income, costs and expenses in interim periods should be the same as in the annual financial statements

Compliance with NIF

- Example: the policies for the recognition of impairment losses in an intermediate period **should be the same** as those that apply to an entity if it only prepares annual financial statements

Not waiting to incorporate the effects of COVID-19 in the financial information at the end of the accounting year

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *IMPAIRMENT TESTS (BULLETIN C-15)*

Identification of any indication of impairment

- **Scope of assets:** Goodwill, tangible and intangible assets, long-term assets recorded as capitalizable leases, right-of-use asset, and the assets and obligations (liabilities) associated with an entity's formal plan to discontinue an existing operation..
- **Examples of indications to consider:** fall of stock prices (below carrying amount of securities, net of depreciation), significant reduction in demand or prices for goods and/or services sold, factory and/or shops closures, supply chain disruptions, significant contract losses, important time lags of expansion projects…

  ⇨ Impairment testing is mandatory **at the end of the (interim) reporting period under review** when **there is any indication that an asset may be impaired** (do not wait until the annual testing for intangible assets with an indefinite useful life!)

Inclusion of uncertainties in the forecasts

- Cash flows: consider the implementation of an approach based on **multiple weighted-probability scenarios**
- Discount rate: reassess the different components (risk free rate, **risk premium** related to the asset and/or the country)

Impacts on presentation and disclosures

Points to consider (Bulletin C-15 Paragraphs, 112-122 and following):

- Key assumptions (both actuarial & operational notably on the duration of the crisis, the speed of the rebound, the support measures…)
- Sensitivity analysis
- Major sources of estimation uncertainty

  ⇨ Take into account the **magnitude of the impacts** of the outbreak for the issuer

- ➢ **Ongoing discussions between auditors and companies on how to perform goodwill impairment tests for interim accounts**
- ➢ **The idea of multiple scenarios will be complicated to implement at June 30, just like carrying out large-scale impairment tests**
- ➢ **Uncertainties are very strong in the short-term, but the long-term fundamentals are not necessarily called into question**

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *MEASUREMENT OF INVENTORIES (NIF C-4)*

Write-down of inventories

- Indicators to be considered: perishable or seasonal nature of inventories, partial or total obsolescence, decrease in stock turnover, decrease in commodity prices, severe decrease in selling price of inventories, etc.
  - ⇨ Inventories must be written-down **at the lower** of cost and **net realizable value**

Impact on the allocation of indirect costs

- Indirect costs resulting from « abnormal » production level: an entity may suffer production levels below the range of normal capacity due to the entity's workforce having to stay at home
  - ⇨ Excess overhead resulting from "abnormal" production levels should not be allocated to inventory
  - ⇨ **Recognition of excess overhead as period costs in the income statement**
  - ⇨ Facilities temporary vacant or idle **should continue to be depreciated** unless the facility is permanently abandoned. The "useless" depreciation is not included in stock value

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *DEPRECIATION OF ASSETS (NIF C-6)*

In general	• **Depreciation based** upon an estimate of the **useful life** • It is not possible to cease depreciating the asset when the asset is idle or retired from active use (NIF C-6 Paragraph 46.2.3) • May lead to increase the useful life (due to the « saving » of the asset). The impact should be insignificant but any change would be dealt with prospectively
Particular case	• **Depreciation based** upon **effective usage** of the asset (RARE) • When the asset is not used, no depreciation expense is recognized (NIF C-6 Paragraph 46.2.3)
Other consequences	• If the asset is not used during an extended period, the entity may have to question its recoverable amount (Bulletin C-15) • In other words, an impairment test would be required in this case (which may not necessarily lead to an actual impairment)

COVID-19 : ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *FINANCIAL INSTRUMENTS*

Financial assets measured at fair value under

NIF B-17

(applies in cases that the specific NIF is permitted)

Price volatility and market activity:

- ⇨ As long as a market is considered to be active, and the transactions are "non distress", observable market prices (stock market prices) must be retained despite the unusual volatility (e.g. stock market)
- ⇨ When a valuation input is no longer considered observable in an active market, a **change in the level of fair value** may need to be made and **additional information in the notes to the financial statements** may need to be disclosed (key assumptions, sensitivity analysis, major sources of uncertainty relating to the estimates used

Impairment of financial instruments receivable under NIF C-16

Decrease in credit quality of debtors: the expected credit losses model requires to take into account forward-looking information (including macro-economic information).

- ⇨ **Careful monitoring of late payments,** aged trial balance review
- ⇨ **Analysis of the need to update the provision matrix** used in determining the expected credit losses in order to consider the consequences of the Covid-19 crisis. Analysis to be carried out by sector if applicable
- ⇨ Provide **qualitative** and **quantitative disclosures** in the notes to the financial statements (NIF C-16 Paragraphs 61 to 65)

  For example: impact of the crisis and measures taken by public authorities on the impairment of trade receivables, how the forward-looking information relating to Covid-19 has been incorporated in the determination of expected credit losses ...

COVID-19 : ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *FINANCIAL INSTRUMENTS*

Cash and cash equivalents

- In a context of high volatility and liquidity tension, particular attention must be paid on whether a financial asset recognized in Cash and cash equivalents still qualifies to the conditions (i) of subject to an insignificant risk of change in value, and (ii) of highly liquid (IAS 7)
  - ⇨ If a financial asset no longer meets the definition of Cash and cash equivalents, **accounting reclassification is required and may impact net debt ratios**

Financial instruments payable (NIF C-19) (NIF B-6) (NIF B-13)

- **Debt renegotiation:** assess any significant changes in the conditions of existing debt to determine whether it results in a **modification** or **extinguishment** of the financial instrument (NIF C-19 Paragraph 42.5)
- Monitor the validation of **debt covenants**, whether waivers have been granted or not, or whether renegotiations of covenants are needed
  - ⇨ The breach of covenants may have an impact on the classification of debts between current and non-current (unless a waiver has been obtained as of the closing date or the date of issuance of the financial statements) and entails a risk on liquidity (NIF C-19 Paragraph 51.8), (NIF B-13 Paragraph 12), (NIF B-6 Paragraph 57.3).
  - ⇨ Information in the notes to the financial statements must be provided in case of breach of covenant / waiver obtained

COVID-19 : ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *FINANCIAL INSTRUMENTS*

Cash management & liquidity risk

- Pay special attention to <u>the liquidity risk</u>
  - ⇨ **Identify the sources of funding available** in order to secure significant future payment deadlines
  - ⇨ Specific point of attention for companies with significant use of funding by the market
  - ⇨ Take into account of moratorium granted by banks and funding guaranteed by public authorities

Factoring & Securitization

(NIF C-14)

(off balance sheet programs)

- Importance to check whether the <u>program still meets the derecognition requirements of the transferred trade receivables,</u> and the sustainability of the program is still valid
  - ⇨ <u>*Examples of indicators to consider*</u>: Increase in late payment by debtors may lead to the early termination of the program, validity of credit insurance in this context of crisis, change in the credit insurance limits?
- For securitizations, check that the program has the capacity to refinance itself on the market in such context of liquidity tension

Derivative financial instruments and hedge accounting (NIF C-10)

Cash Flow Hedge:

- Need to determine whether the hedged cash flows are still highly probable given the slowdown in activity
  - ⇨ If the hedged forecasted transaction ceases to be highly probable, the hedging relationship must be stopped prospectively
  - ⇨ Accounting treatment of hedging derivative gains or losses accumulated in the Cash Flow Hedge reserve (OCI) before the end of the hedging relationship:
    - If the hedged forecasted transaction is still expected to occur: that amount is **maintained into OCI until the hedged transaction impacts profit or loss**
    - If the hedged forecasted transaction is no more expected to occur : that amount is **immediately reclassified from OCI to profit or loss**

COVID-19 : ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *FINANCIAL INSTRUMENTS*

Disclosures on financial instruments under

Set of NIF C

- In this context of high market volatility, liquidity tension, and short-term economic uncertainty, special attention must be paid to the disclosure to be provided in the notes to the financial statements as regards exposure to financial risks and the impact that they may have on the financial situation of the company

.

- These include liquidity risk, credit risk, foreign exchange risk, interest rate risk, market price risk, etc.

Examples of information to consider in this context : *additional information on significant concentration of credit risk, cases where a lack of liquidity can have a significant impact on the going concern of an entity's activities, impact of a business interruption on liquidity, description of the range of available funding, sensitivity to changes in exchange rates, sensitivity to changes in interest rates, etc.*

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *REVENUE (NIF D-1)*

Existence of a contract with a customer

- Backlog determination: no contract if it is not probable that the entity will collect the consideration to which it will be entitled (i.e. taking account of the customer's credit risk)
  - ⇨ Revenue to be recognized for the consideration received from the customer **only in specific situations as listed by NIF D-1**
- Contract modifications: different **consequences** whether the remaining goods or services to be provided are **distinct** from those transferred on or before the date of the contract modification

Revenue estimate

(variable considerations)

- Reassessment of variable considerations (rebates, late penalties, product returns, etc.): revenue to be recognized only if it is **virtually certain** (possibly significant judgment)
  - ⇨ **Immediate** adjustment to revenue (on a cumulative catch-up basis), where relevant
- Renegotiation of payment terms: contract modification that should lead to reassess the existence of a significant financing component (if relevant)

Revenue recognition

- Reassessment of the criteria of existence of a contract: no more contract if it is no longer probable that the entity will collect almost all the consideration (to be distinguished with situations where the entity decides to grant a price reduction to the customer, see 2nd section above)
  - ⇨ Impacts on the residual amount in backlog and on the **timing of revenue recognition for unrecognized revenue** (see 1st section above)
- Significant inefficiencies (i.e. not reflected in the initial transaction price): **immediate impact in P&L** and **no impact on the method for measuring progress** (i.e. no recognition of revenue)

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *PROVISIONS (NIF C-9)*

Future operating losses

- Provisions shall **not be recognized** for future operating losses or for costs to be incurred to restart activities
- **Indication** that certain assets of the operation may be impaired (see Bulletin C-15, impairment tests)

Restructuring (reduction of activities, sites closures...)

- Recognition criteria for provisions for restructuring costs: only if a past event has given rise to a **present obligation for the entity to restructure** (i.e. the mere decision to restructure does not create a present obligation) and if a **reliable estimate** can be made of the amount of the obligation (i.e. a detailed formal plan shall be available)
- Several costs are to be excluded from the provision for restructuring costs (such as relocation costs): to be recognized in P&L when **actually incurred**
- Redundancy payments: accounting treatment possibly **complex** and shall be based on all relevant facts and circumstances

Onerous contracts (accounting for losses at completion)

- Recognition criteria for provisions for onerous contracts (after taking account of impairment of contract-related assets, if relevant) : if the **unavoidable costs** (i.e. **the lower** of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it) exceed the economic benefits expected to be received under the contract
  - ⇨ Assess the economic implications of **early termination clauses**
  - ⇨ If relevant, assess the legal implications of “force majeure” contractual clauses over **the rights and the obligations of the parties under the contract**
- Contracts with customers: take account of impacts related to re-estimates of revenue yet to be recognized (late penalties, etc.) and re-estimates of costs yet to be incurred (increase in sourcing costs, extra cost of available workforce, etc.)
  - ⇨ No impact (on the provision for onerous contracts) of significant inefficiencies already recorded

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *EMPLOYEE BENEFITS (NIF D-3, NIF D-8)*

Short-term paid absences due to reduce activity
(NIF D-3)

- The consequences of the various measures aiming at reducing activity (containment, sick leave, reduced activity) **cannot lead to the recognition of a long-term liability** (NIF D-3 Paragraph 42.1.1). It includes namely:
  - The wages of workers forced to stay at home who cannot work from home
  - The remaining charge for the entity related to the measures of partial activity
  - The remaining charge on sick leaves

Share-based payments
(NIF D-8)

- Reassessment of **estimations linked to vesting conditions,** and adjustment of the number of instruments the entity now expects to grant:
  - Achievement of performance conditions
  - Fulfilment of presence condition if the entity considers staffing reductions
- **Change in the plan provisions**: to be taken into account if they are benefitting the employee

Measurement of pension liabilities
(NIF D-3)

- If the impact is significant on interim accounts, review certain actuarial assumptions such as:
  - Discount rate,
  - Probability and settlement date by the employees of certain acquired rights
  - Link with provision for restructuring costs

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *INCOME TAX (NIF D-4)*

Scope: does NIF D-4 apply?

- **Income tax or other taxes?**
  - NIF D-4 applies to the accounting of income tax
  - Other taxes and levies are within the scope of NIF C-9
- **Income tax or government grant?**
  - Tax credits are not defined!
  - Judgment may sometimes be required (see the following slides on International Accounting Standard IAS 20, *Accounting for Government Grants and disclosure of Government Assistance*, by supplementation, because the Mexican NIF is not regulated)

Tax laws enacted after the end of the reporting period

- Under D-4, income tax (both current and deferred) is measured on the basis of tax laws that have been **enacted or substantively enacted by the end of the reporting period**:
  - The assessment of what « substantially enacted » means is performed **jurisdiction by jurisdiction** (consider each jurisdiction's legislative procedures and practices)
  - Tax laws that have been **substantially enacted only <u>after</u> the end of the reporting period** will be considered **non-adjusting events**

Uncertainty over income tax (IT) and employee profit-sharing (EPS) treatments

(NIF D-4, NIF D-3)

- In a context of emergency, new tax laws are likely to create uncertainties over the acceptability of certain income tax treatments (is the entity eligible to a particular income tax measure? how does it impact income tax calculation?...)
- To **address uncertainties relating to income tax**, entities need to refer to:
  - NIF D-4 for recognition and measurement issues (Paragraphs 25A to 25E; 36i, 36A)
  - NIF A-7 (judgments and sources of uncertainty) and NIF C-9 (contingent tax assets and liabilities) for disclosures

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *INCOME TAX (NIF D-4)*

Understanding the effects of these new tax laws over time

- **Extended deadlines for settling income tax liabilities** usually have no impact under NIF D-4 (DTA/DTL are never discounted). However, each income tax measure needs to be carefully analyzed to identify all potential consequences relating to income tax
- **Other income tax measures** might raise more complex issues when **determining temporary differences** and **their projected timing of reversal** (e.g. the tax rate to be used for measuring deferred tax may depend on the future period in which a temporary difference reverses…)

Assessing the recoverability of Deferred Tax Assets (DTA)

- **Availability of taxable temporary differences at the end of the reporting period** (against which temporary deductible differences could be utilized): consider the **effect of new tax laws** (if they have been enacted or substantively enacted by the end of the reporting period)
- **Assessment of future taxable profits:**
  - very little guidance in NIF D-4 *(but the July 2019 Public Declaration of the European Securities and Markets Authority (ESMA): ESMA's July 2019 Public Statement on DTA from unused tax losses may be helpful for measurement and disclosure issues, as long as it does not oppose NIF D-4)*
  - in projecting future taxable income, use caution as the economic environment is highly uncertain
- **Tax planning opportunities:**
  - the current economic environment may cause entities to revise their tax strategies
  - new tax laws may create additional opportunities

Interim financial information (NIF B-9)

- Reminder: income tax and employee profit-sharing expense is measured (judgment may be required to determine whether some tax benefits relate to a "one-off" event in a particular interim period and should thus be fully recognized in that interim period)

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *PROFIT OR LOSS PRESENTATION (NIF B-3)*

Reminder

- NIF B-3, *Statement of comprehensive income*, prescribed that costs and expenses related to an entity's operating activity must be included and that they are identified with net sales or income and must be associated with relative sales or income.

- NIF B-3 **does not establish “unusual expenses”** and costs that must be presented in the income statement (under conditions called “non-recurring” income and expenses)
  - ⇨ Topic which is subject of particular attention from regulators

Items that CAN NOT be presented as “non-recurring”

- Incremental costs directly linked to the protection measures implemented by entities (site cleaning, employee protection equipment, etc.)
- Costs related to sub-activity: provided that it is possible to **reliably** isolate the share of fixed overhead costs not allocated to the production cost of inventories which results **directly** from the current health crisis
- Partial unemployment: **net** cost borne by the entity notably due to the shutdown of production sites (i.e. payments to employees net of compensation received from governments)
  - ⇨ **Caution should be taken so that the entity DOES NOT present "non-recurring"** costs and expenses of consequences related to the COVID-19 crisis.

- ➢ **There are some expenses that, even when they are not frequent, are inherent to the operating activities of the entity, so they must be presented in the line of costs and expenses that are identified with relative sales or income.**
- ➢ **Examples of these non-recurring expenses are: costs of a strike, or reparations for damages of a natural phenomenon**

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *INSURANCE RECOVERIES*

General principle

- An insurance recovery is a **contingent asset (i.e. not recognized)** as long as it is not **virtually certain** that the damage will be covered by the insurance
  - Assuming a probability close to 100%
  - Could generate a timing difference between the accounting for the damage (through a loss or a provision) and the accounting for the insurance recovery
- The triggering event of the right to be compensated is the accounting for the damage
  => Neither asset nor contingent asset before this date
- **Disclosures in the notes** relating to contingent assets when it is **probable** that the damage will be compensated but not virtually certain

Approach

- Analysis of the insurance policy to **determine the eligibility of the damage** and the scope of the compensated losses
  - Exclusion clauses
  - Damage documentation conditions

  ⇒ Necessary for the documentation of the virtually certain criterion of the compensation

  ⇒ A **confirmation of the insurer** that the damage is in the scope of the insurance policy is a useful proof
- **Uncertainties linked to the amount** of the indemnification
  - Do not challenge recognition, but influences measurement
  - Take a prudent approach, based on the capacity to document the claim for compensation
  - If relevant, add disclosures in the notes on significant judgments and major sources of estimation uncertainties

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *DECREASE IN LEASE PAYMENTS (NIF D-5)*

In general

- Normally analyzed as a **lease modification** (because the amount has been bargained between the lessor and the lessee)
- The debt is adjusted (new lease payments, discounted with a revised discount rate), against the right of use (ROU)
- In practice, **positive impact spread over the ROU residual period**

Particular case (NIF D-5)

- If the lease states some instances of lease reductions AND the decrease in lease payment (NO bargaining between lessor and lessee)
- Adjustment related to an index or a rate: adjustment of debt (discount rate unchanged), against the ROU => positive impact spread over the ROU residual period
- Adjustment not related to an index or a rate: immediate P&L impact (i.e. ROU unchanged)

Particular case (IAS 20)

- When it is considered that the lessor is acting on behalf of the State (i.e. the lessor receives instructions from the State and acts accordingly)
- IAS 20 principle: a grant is recognised in P&L on a systematic basis over the periods in which the entity recognises the « subsidized » expenses
- If the grant is related to income, positive impact would possibly be immediate
- If the grant is related to assets, positive impact spread over the asset useful life

➢ **The strict application of NIF D-5 would result in spreading (through a reduction in the depreciation of the right of use) the benefit of this temporary decrease in rents, when it is intended to compensate for a loss of activity**

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *CAPITALIZATION OF COMPREHENSIVE FINANCING RESULT (NIF D-6)*

General principle	The capitalization of the Comprehensive Financing Result (CFR), as part of the total acquisition cost of qualifying assets, must begin when all of the following conditions are met and continue to be present: a) the necessary activities are being carried out to prepare the asset for the intended use or for sale, b) Investments have been started to acquire qualifying assets, and c) interest has accrued
Suspension of capitalization of the Comprehensive Financing Result (CFR)	The capitalization of the CFR should be temporarily suspended during the periods in which the development of activities is interrupted, only if the interruption (s) extend significantly over time. An exception to what is indicated in the previous paragraph is when interruptions in the development of activities are for short periods or according to the nature of the project. In this case, the CFR capitalization process should not be suspended

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *FOREIGN CURRENCY TRANSLATION*

The variation in the peso exchange rate has been significant with respect to other currencies, so currency transactions must recognize the corresponding effect in accordance with NIF B-15, *Translation of foreign currencies*

Reminder

Initial recognition
All transactions in foreign currency must be initially recognized in the registration currency applying the historical exchange rate.

The date of a transaction is the date on which said operation accrues and meets the conditions for its recognition in accordance with the Financial Reporting Standards (NIF)

Subsequent recognition and conversion standard

- At the closing date of the financial statements, the balances of monetary items derived from transactions in foreign currency and that are denominated in foreign currency must be translated at the closing exchange rate.
- Also, on the date of realization (collection or payment) of transactions in foreign currency, they must be translated at the exchange rate of realization. From these procedures differences in exchange arise because normally the closing exchange rate or, where appropriate, the exchange rate on the date of realization, has variations with respect to the historical exchange rate.
- Regarding non-monetary items, they must be maintained at the historical exchange rate as initially recognized

Differences in determined changes must be recognized as income or expense in net profit or loss in the statement of comprehensive income in the period in which they originate

a) Those differences that are capitalized as part of the cost of an asset in accordance with NIF D-6, *Capitalization of comprehensive financing result*; and

b) Those derived from a liability in foreign currency that has been designated and qualifies as economic hedge of the net investment in a foreign operation, which is recognized in equity, forming part of the *accumulated effect of conversion*

Exception

COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *GOVERNMENT GRANTS (IAS 20)*

In the event that the Government of Mexico announces Grants for companies derived from the economic crisis caused by COVID-19, and since there was no regulation in the Mexican NIF for the accounting treatment of Government Assistance, by the supplemental prescribed in Mexican NIF A-8, the International Accounting Standard IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, would have to be applied.

Those Mexican companies that have subsidiaries abroad in whose countries the Governments grant support for the COVID-19 crisis, should consider IAS 20, prior to consolidating or recognizing by the equity method, their investment in those companies.

Reminder

- In general, subsidies are granted subject to the entity complying to certain conditions
- A grant may not be subject to any particular conditions (in which case grants would generally only benefit certain economic sectors)
- Scope – If a grant is subject to the level of taxable profit, then it is excluded from the scope of IAS 20 (and would normally be in the scope of NIF D-4)

General principles

- **When is the grant accounted for?** – A grant is recognized when the entity has a reasonable assurance that (a) the entity will comply with conditions attached AND (b) the grant will be received
- **P&L Impact** – The grant is recognized in P&L on a systematic basis over the periods in which the entity recognises the « subsidized » expenses (i.e. matching principle)

Presentation

- If the grant is related to assets, there is an accounting choice (deducting the grant from the cost vs. deferred income). In both instances, the depreciation expense is reduced
- If the grant is related to income, there is also an accounting choice (accounted for in « other income » or deducted from the related expense)

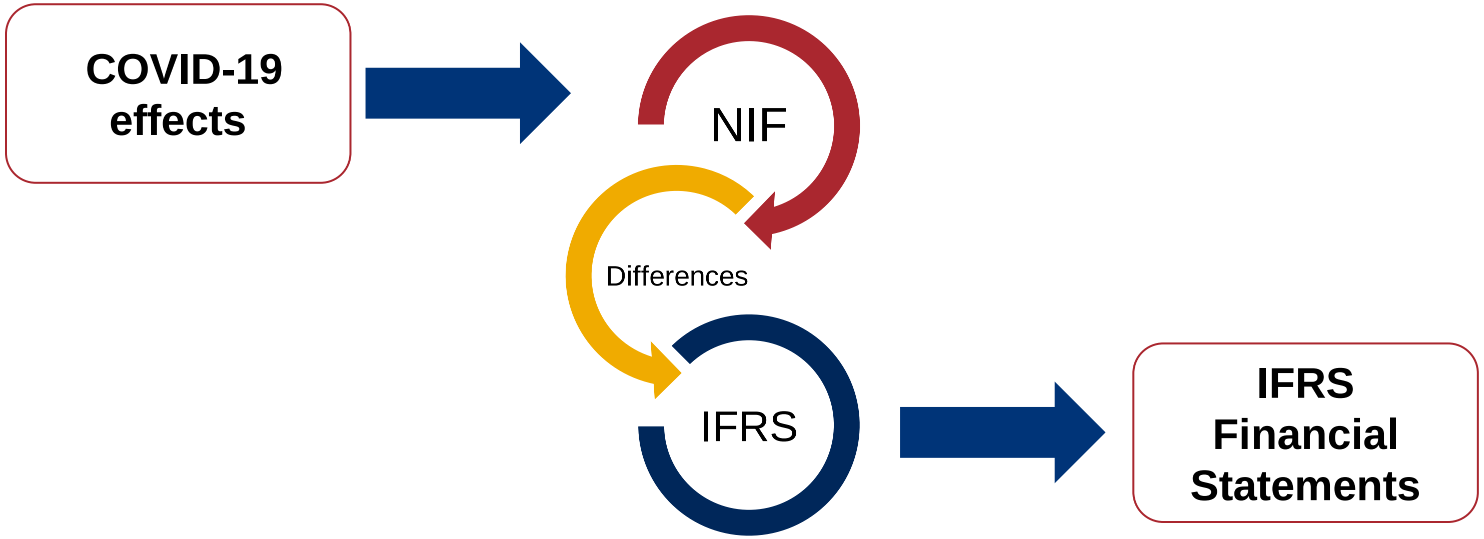
COVID-19: ACCOUNTING IMPLICATIONS EXPECTED FOR 2020 – *DIFFERENCES FROM INTERNATIONAL FINANCIAL REPORTING STANDARDS*

Reminder

The purpose of the Mexican Financial Reporting Standards (NIF) is to converge with the International Financial Reporting Standards (IFRS), except for those aspects in which according to the business environment in Mexico and certain legal aspects, has decided to maintain some differences

Exceptions

The effects derived from COVID-19, in the financial information of a company, may be different when applying NIF or IFRS, therefore, care must be taken to identify the cases in which these differences are present. Mazars advises you to determine what are the differences that affect your company



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