Accounting considerations of the COVID-19 pandemic

Dirección de Contabilidad, Planeación y Presupuesto

May 2021

BANCO DE MÉXICO

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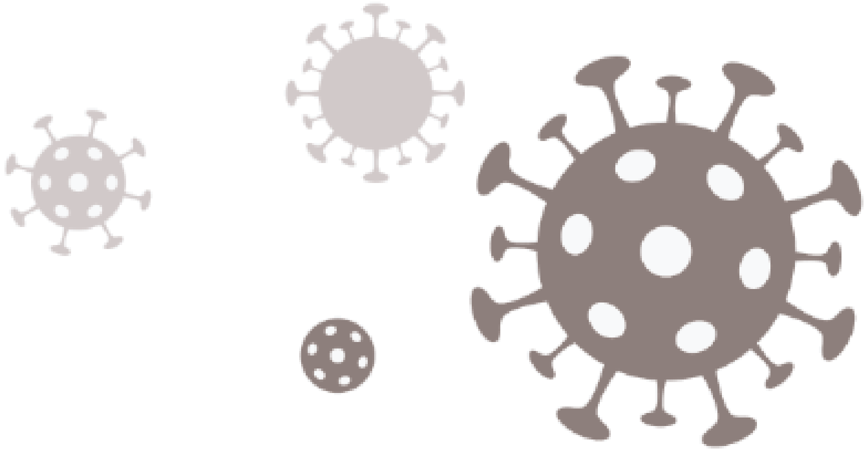
Introduction

- In the process of development and enactment of Financial Reporting Standards of Banco de México, a basic principle is to maintain convergence with the regulations issued by the Mexican Financial Reporting Standards Board (CINIF for its Spanish acronym), provided that there is no conflict with the legal framework regulating the Bank or with the operations inherent to its nature.

- Due to the impact of the COVID-19 pandemic on entities´ operations. During 2020, the CINIF Research and Development Center issued technical reports with accounting considerations to be taken into account.



Background information

- The potential accounting and financial reporting implications are situations already foreseen in the Mexican Financial Reporting Standards (FRS).
- However, it is necessary to assess the entity's ability to cope with the significant disruption to normal operations and continue as a *going concern.*

Economic entity is presumed to be in permanent existence, within an unlimited time horizon, in the absence of proof to the contrary.

In evaluating this assumption, management should consider all available information for the future, covering at least the next twelve months.

When this postulate is not met, estimated **realization or liquidation** values should be used, which would be derived from the eventual disposal of assets or liquidation of liabilities.

Major impacts

- Some of the most important effects of the pandemic on the operations include:

  - Disruptions to supply chains.
  - Labor force shortage.
  - Collection problems.
  - Cash flow pressures.
  - Total or partial closure of businesses.
  - Variation in market prices.
  - Volatility in the values of financial instruments.

The obvious consequences of the above include the possibility of having to adjust the value of entities **assets and liabilities**.

Major impacts

- The use of *forecast information* is essential in the evaluation of the following concepts:

  - Estimated expected credit losses.
  - Impairment testing of long-lived assets.
  - Asset recoverability.
  - Ability to continue as a ongoing concern.

- The economic and pandemic crisis makes the preparation of forecast information more complex, it is of extreme importance to make reasonable and careful estimates considering the prevailing uncertainty.

Impact on financial statements 2019 and 2020

- In preparing the 2019 financial statements, subsequent events could be identified that required:

  - Disclosure only
  - Adjustment and disclosure

- The spread of the pandemic in the first months of 2020 did not provide any evidence to consider that such a situation existed at the close of the 2019 financial year: *these were new events that appeared in 2020.*

- In CINIF's opinion, the disruption that occurred as of January 2020 were events subsequent to the 2019 financial statements that only required disclosure and not adjustment.

Impact on financial statements 2019 and 2020

- Information required to be disclosed in the 2019 financial statements about events that in the evolution of the pandemic occurred between the closing date and the date of issuance, as well as the impacts that could be on the future book value of assets and liabilities:

- The nature of the event and an estimate of its impacts should be disclosed or, if applicable, a statement of the impossibility of making such an estimate.

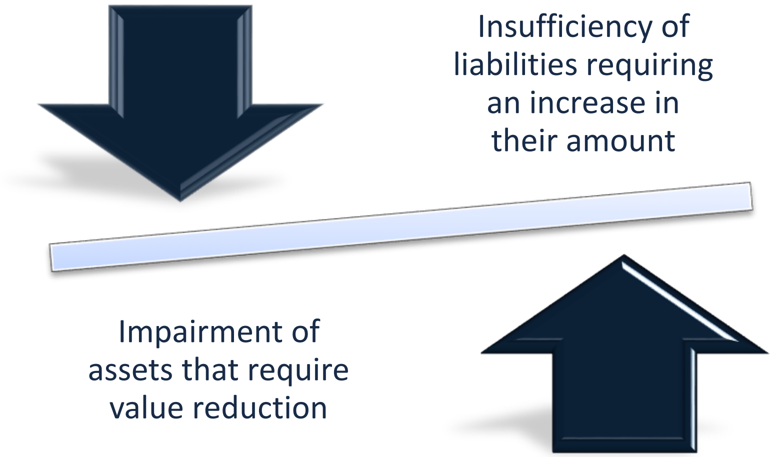
- If at the date of issuance of the financial statements management foresaw that, in the future 12-month period, the entity might cease operations, it should evaluate whether it was appropriate to prepare its financial statements under the going concern assumption.

In the case of Banco de México, it was determined that no disclosure regarding pandemic-related events was required in the 2019 financial statements.

Impact on financial statements 2019 and 2020

- As the year 2020 progressed, more data became available regarding the scale and economic impact of the pandemic and it became critical to evaluate the events caused by the pandemic to determine if they represented events requiring adjustment.

- During 2020, management had to evaluate:
  - Whether it was appropriate to continue to prepare the financial statements under the basic going concern basis.
  - All financial information subject to professional judgment and uncertainty:



Impact on financial statements 2019 and 2020

- Presentation of the effects of the pandemic in the 2020 statement of comprehensive income:

Many entities evaluated to present the costs, expenses and losses associated with the pandemic separately and outside of operating income as extraordinary expenses so that the reader could differentiate between normal operating and extraordinary pandemic costs.

The regulations establish that, even though there may be some expenses that are not frequent, they must be considered inherent to operating activities and do not allow the presentation of items in a segregated way.

Therefore, the effects of the pandemic should be presented within operating income and should not be presented separately as extraordinary or non-ordinary items.

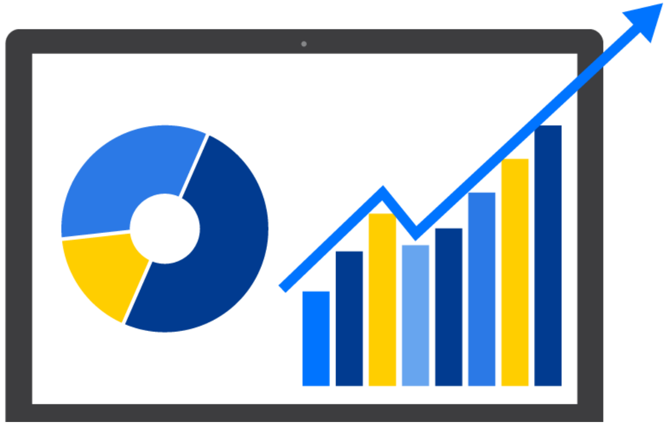
Main issues to be considered in 2020

- **Expected credit losses**
  - An entity should not wait until there is objective evidence of impairment of a financial instrument receivable or it meets an internal definition of default.
  - Considering the magnitude of the possible effects of the pandemic, existing conditions should be evaluated and reasonable and supportable forecasts of the different quantifiable effects that could affect the future cash flows of the financial instruments receivable should be updated.

- **Inventory valuation**
  - Taking into consideration that fixed production overhead is allocated based on normal production capacity, if the level of manufacturing is abnormally low, inventory costs should be reviewed to ensure that fixed overhead not allocable to inventory is recognized in the statement of comprehensive income in the period in which it is incurred.

Main issues to be considered in 2020

- **Valuation of long-lived assets**
  - Impairment - Entities are required to perform impairment tests when there is an indication that a long-lived asset may be impaired. As a result of the pandemic, for some entities it may have been necessary to perform additional impairment assessments prior to the end of financial year 2020.
  - Depreciation - In the event of a change in the manner in which assets are used and their economic benefits are obtained, entities were required to evaluate the possibility of modifying their depreciation methods; given the case, any change should have been recognized prospectively as a change in circumstances.



Main issues to be considered in 2020

- **Leases**
  - Lease contracts. Entities should evaluate the effect of a possible decrease in lease payments, because several leased assets are not being used as planned, and lessees are seeking to renegotiate contracts.
  - Rent waivers. If a change in lease payments results from a modification to the contract, the lessee must determine a new discount rate to remeasure the liability, and the adjustment to the liability is matched by an adjustment to the right-of-use asset. If the change does not result from a modification, it would be recognized by the lessee as a variable payment, recognizing the effect of the waiver in net income or loss as a partial extinguishment of debt in the period in which the event or condition that triggers the payments occurs, without adjusting the right-of-use asset.

Main issues to be considered in 2020

- **Leases (cont.)**

  - <u>Impairment of right-of-use assets.</u> After the beginning of the lease, a lessee must measure a right-of-use asset at cost, less accumulated depreciation or amortization and accumulated impairment losses.

A lessee must determine whether the right-of-use asset has an indication of impairment. Again, as a result of business closures, disruption in supply chains and other consequences of the pandemic, future cash flows from the use of the underlying asset may be diminished and result in impairment losses.

Main issues to be considered in 2020

- **Fair value determination**
  - Determination should reflect the perspective of market and participant information as of the valuation date under current conditions.
  - Entities should pay particular attention to the inputs, especially the *unobservable data* used, to ensure that they consider how market participants would reflect the effects of the pandemic in their cash flow expectations.

- **Revenue recognition**
  - An entity should consider all available information to identify a reasonable range of possible consideration amounts, and should include in the transaction price all or part of the amount of estimated variable consideration only to the extent that it is highly probable that a material reversal of the amount of cumulative revenue recognized will not occur.
  - Entities should assess whether the effects of the pandemic could result in reduced demand, increased returns, additional discounts or late delivery penalties.

Main issues to be considered in 2020

- **Non-compliance with financial covenants**
  - For entities facing business interruptions as a result of pandemic control measures, this will likely result in lower revenues and collection delays, with negative impact on their cash flow to meet their debts.
  - Many covenants include contractual clauses, compliance with which may be at risk in the current environment. In such a case it should be considered that the presentation of the debt as a long-term liability may no longer be appropriate.

- **Hedging relationships**
  - The possibility that cuts in supply chains and the reduction of activities may affect operations should be evaluated.
  - The entity should review whether it is still probable that the projected transactions that were previously designated in cash flow hedging relationships will occur or whether the hedging instrument is still effective.

Main issues to be considered in 2020

- **Materiality judgments and uncertainties**
  - Entities should disclose key assumptions used in the determination of accounting estimates that involve uncertainties that have a significant risk of causing material adjustments to the values of assets or liabilities within the next accounting period.
  - Under the current circumstances caused by the pandemic, the high level of uncertainty may complicate the exercise of professional judgment, which emphasizes the need for adequate disclosure in the financial statements.
  - Each entity should determine which judgments and uncertainties, because of their significance, require disclosure.

Main issues to be considered in 2020

➢ Classification of financial assets

- Financial instrument assets are classified into four categories, according to the entity's business model, which is based on the way in which financial instruments are managed to generate cash flows and not on a particular intention to hold an instrument.

- As a result of the pandemic, some entities may carry out sales to respond to specific liquidity needs or in response to an increase in credit risk, which would not normally be a sufficient argument to justify a change in business model, and only a significant increase in the frequency and amount of such transactions could justify such a change.

Main issues to be considered in 2020

- **Employee benefits**

  - At the end of each reporting period the present value of the defined benefit obligation and the fair value of plan assets should be determined; economic uncertainties associated with the pandemic could affect that determination.

  - As a result of the pandemic, some entities may need to consider how to preserve cash to conserve liquidity. This could result in the need to modify the disclosure of expected plan contributions for the next annual period.

  - A detailed analysis is required to ensure proper recognition of all labor obligations and may require recognition of liabilities or provisions:

    - if contributions cannot be made due to lack of liquidity;
    - decline in value of plan assets;
    - immediate actions to reduce the workforce;
    - payment of special bonuses, etc.

Main issues to be considered in 2020

- **Guarantees**

  - When providing a financial guarantee which an entity makes a commitment to a third party to settle a debt in the event that the original debtor is unable to meet the debt, a provision should be recognized for the portion of the obligation for which an outflow of resources is probable. In this situation, the entity should consider how the original debtor is affected by the pandemic and, depending on the circumstances, it may be necessary to recognize an additional provision.

- **Disclosure of risks on financial instruments**

  - With respect to risks on financial instruments, the risks that arise and how they are managed, the exposure and origin of each type, as well as the objectives, policies and processes for their management and the methods used for their mitigation must be disclosed. In addition, any changes during the period should be disclosed. In view of the current situation, significant changes are expected in some of the risks and their management, which should be evaluated by each entity to determine the necessary disclosures.

Main issues to be considered in 2020

- **Delays in Completion of Planned Transactions**

  - The pandemic may result in delays in the completion of some planned transactions, including business acquisitions, and may complicate the evaluation of subsequent information and post-acquisition events to determine whether facts or circumstances exist, which existed at the acquisition date requiring an adjustment to the acquisition amounts recognized, that represent a modification to goodwill.

Banco de México's measures to face the pandemic

- Measures adopted in April 2020 by Banco de México to strengthen the financial sector in the face of the pandemic

Increased liquidity during financial market operating hours if necessary.

Expansion of eligible securities in repo transactions under the Ordinary Additional Liquidity Facility (OALF), guarantees for foreign exchange operations for differences in local currency and credit auctions in dollars.

Expansion of eligible counterparties for OALF, allowing access to development banking institutions.

Window for the purchase of government securities under repurchase agreements at terms longer than those regularly used in open market operations.

Temporary collateral exchange window for eligible institutions to deliver debt securities in exchange for government securities.

Banco de México's measures to face the pandemic

- Measures adopted in April 2020 by Banco de México to strengthen the financial sector in the face of the pandemic (cont.)

Corporate Securities Repurchase Facility to credit institutions to provide liquidity to short-term corporate bonds and long-term corporate debt.

Provision of resources to banking institutions for granting loans to micro, small and medium-sized enterprises and individuals affected by the pandemic.

Financing facility for multipurpose banks guaranteed with loans to companies that issue stock debt, to increase the lines of financing to micro, small and medium-sized companies.

Swap of government securities, receiving long-term securities (10 years or more) and delivering others with terms of up to 3 years.

Extension of the hours for arranging foreign exchange hedges settled by differences in U.S. dollars.

Banco de México's measures to face the pandemic

- In Banco de México's financial statements for fiscal year 2020, mention was made of the pandemic and its effects:

Legal framework and nature of operations	• The Bank has contributed to the functioning and stability of domestic financial markets and their healthy development, approving measures to provide liquidity so that credit institutions can grant financing to the economy. • Even with confinement measures, the Bank's activities, processes and operations have generally remained operational and in force, allowing it to achieve its goals.
Credit granted to banks and debtors from repo operations	• The Board of Governors approved measures to provide liquidity to improve the functioning of domestic markets, strengthen credit granting channels in the economy and promote the orderly behavior of the Mexican debt and foreign exchange markets. • The amount of transactions for the implementation of facilities granted through repo operations was disclosed.
Risk management - Financial stability	• As part of the measures taken by the pandemic, credit institutions have access to Central Bank financing, provided they comply with the requirements of the corresponding criteria. • The risk management scheme considers the particular characteristics of the financing and the assets susceptible to be received as collateral, in order to cover the Bank's exposure to financial risks.

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