How has COVID-19 affected financial reporting?

Analysis of the impact on June NZX50 reporters

Following our earlier publication looking at the impact of COVID-19 on financial reporting for NZX50 March to May reporters, we have analysed the effect on NZX50 companies reporting in June. These later reporters experienced the full impact of the Alert Level 4 and 3 lockdowns. How did it play out in their financial reporting?

Number of audits completed by each firm:	
Deloitte	**6**
KPMG	**6**
EY	**5**
PwC	**5**

Source: NZX50 (22 September 2020)

Utilising NZX reporting relief

Of the businesses listed on the NZX50, 22 have a 30 June balance date. All these entities have now reported.

We noted in our last analysis that five out of the March to May reporters utilised the NZX 30 day extension of the usual two month reporting requirement under the listing rules. Given the challenges around preparing financial statements and having them audited while financial reporting teams, management, directors and auditors were working remotely, we expected more companies to make use of the relief in March to May.

For 30 June reporters our expectation was different. Mostly, the preparation of financial reports and audit thereof took place outside of the lockdown periods meaning that more entities could likely meet the same timeline of prior periods.

Eighteen of the 22 entities reported within five days of when they reported last year. In fact, many reported earlier or on the same date. This is impressive given it includes Air New Zealand and Auckland International Airport who have been significantly affected by COVID-19. Only four companies utilised the relief to report later than they previously have.

Reporting the impact of COVID-19

The precedent set by Z Energy of including a detailed note considering the impacts of COVID-19 on key financial statement line items in its 31 March financial reporting has continued. Fifteen of the later 22 reporters took the same approach. For those companies where the consequences of the pandemic have been more pronounced, a key note pulling the effects together is particularly helpful to the users of the financial reports. Companies that didn’t include a similar note were either less affected or, the impacts were more focused on certain financial statement lines. These impacts were covered adequately in the applicable notes in the financial statements.

Key findings:

22 businesses

on the NZX50 with June year ends have now completed their financial reporting

18 businesses

reported close to, or at the same, time as the prior year

4 businesses

utilised the NZX's 30 day extension on reporting requirements

10 businesses

claimed the wage subsidy – amounting to a total of $177.5m

15 reporters

included a detailed COVID-19 related note in the financial statements

6 reporters

with investment property highlighted material uncertainty clauses included by registered valuers in their valuations

(this is consistent with March to May NZX50 reporters)

46%

10 of June NZX50 reporters recorded impairments of non-financial assets

An additional **$50m** of provisions for doubtful debts were recorded across these 22 businesses

Many companies have closed out derivative positions, incurring losses, due to the forecast transactions they were to hedge no longer being expected to occur.

9 businesses

did not declare a dividend as a result of COVID-19 uncertainty

All 22 reporters

had 'clean or green traffic light' audit reports

Many new KAMs

were included in audit reports as a result of COVID-19

The story of the wage subsidy

Of the 22 June reporters, ten claimed the wage subsidy – amounting to $177.5m. Only four of those that claimed the wage subsidy made a net loss for the year. However, this is a simplistic way to analyse whether a company should have claimed the subsidy. It is likely that many of the businesses who claimed the subsidy would have reduced their employee numbers quickly if it hadn't been available.

Companies were transparent, usually by way of a narrative, in disclosing the quantum of wage subsidy received. Yet, there was no consistency in presentation. The accounting standards permit a company to either report the subsidy as other income or as a reduction of expenses. Often a narrative explanation was included detailing how the subsidy had been treated.

On reflection, given the public interest in wage subsidies there was a missed opportunity for standard setters and regulators to have made their expectations clear when it comes to reporting the wage subsidy so we had consistency in reporting.

Rental concessions

Spark, Fletcher Building and Tourism Holdings (thl) disclosed that they had received rent relief from landlords. These concessions were treated as a reduction of rental costs directly in profit or loss. This is consistent with the COVID-19 practical expedient that accounting standard setters put in place. The quantums of rent relief received were not disclosed.

The shock to the aviation and tourism sectors

In late August the significant impact of COVID-19 on the aviation sector became apparent when Air New Zealand and Auckland International Airport (AIA) released their June results.

AIA stated in their financial report "the last six months have been the most challenging of Auckland Airport's 54-year history". They responded promptly to the pandemic with an equity raise of $1.2b in April, agreeing maturity date extensions to bank loans and confirming covenant waivers until December 2021. AIA also cancelled the interim dividend and suspended all future ones while debt covenant waivers were in place. Infrastructure projects of more than $2b were either cancelled or deferred. An impairment of $40m was taken, mainly attributable to the capital work in progress portfolio. On the people front, the pay and hours of directors, management and all employees were reduced with numbers reduced by 25% at 30 June 2020. This was due to the operational reality of a sharp decline and an uncertain outlook for passenger numbers.

Air New Zealand also responded promptly following the steep decline in demand that followed the outbreak of COVID-19. While the company has had difficult times in the past, they reported their first loss in 18 years for 30 June 2020. Like AIA, Air New Zealand moved quickly and a $900m standby loan facility with the New Zealand Government was negotiated early in the pandemic. They also reduced employee numbers by approximately 4,000 to reflect lower levels of anticipated demand through to 2023. This resulted in a $140m restructuring charge.

Like AIA, Air New Zealand has deferred or cancelled $700m in expected capital expenditure, cancelled any non-essential spend, reduced lease costs and, where possible, agreed modified supplier terms. Unsurprisingly, Air New Zealand recorded aircraft impairments of $338m established using a fair value less cost to sell methodology. Aircraft values around the world have fallen with the global reduction in air passenger movements.

The fall in demand has also seen Air New Zealand closing out fuel and foreign currency hedges with a net loss of $105m recorded in profit or loss as the transactions they were to hedge are no longer expected to occur. This has resulted in the gains or losses on those derivative positions having to be transferred from the cash flow hedge reserve to profit or loss. From time to time this does happen, however, it is a feature of the financial reporting for the NZX50 March to June reporters. Many of these companies have closed out derivative positions early, often resulting in losses, on forecast transactions such as foreign currency revenues, fuel costs, or interest flows (with debt being restructured).

Despite international tourism almost drying up overnight, thl reported a strong profit after tax. This included the impact of a full impairment of goodwill in respect of its hibernated Kiwi Experience business of $3.1m. thl noted that in the four months leading up to 30 June 2020 they experienced a 79% increase in US vehicle sale proceeds compared to the same period the prior year. This assisted thl in reducing debt levels by 30% in the last three months of the financial year. Unlike many other tourism operators they have not had to raise additional equity.

Impairment of non-financial assets

Alongside Air New Zealand, AIA and thl, seven other companies also recorded impairments of non-financial assets. This is 46% of the June NZX50 companies – an unusually large proportion. It includes Sky TV writing off goodwill of $178m, Fletcher Building writing off $130m of property, plant and equipment and inventory, Vector impairing $32m in respect of goodwill and intangible assets allocated to E–Co Products (heat pumps and filters businesses) and SkyCity impairing its Adelaide casino license by $160m.

In many cases the disclosures in the financial statements around impairment assessments were more detailed than usual. Additional narrative commentary had been added with good descriptions of the assumptions made. Given the significant uncertainty in estimating future business performance, several companies used projections of multiple scenarios to assess the range of different outcomes that were possible.

Increases in allowances for doubtful debts

Generally, companies recorded increases in the allowance for doubtful debts at 30 June 2020. Most identified that the increase was due to the uncertainty around the economy and employment both in New Zealand and Australia. In aggregate, the 22 reporters increased the allowance for doubtful debts by approximately $50m compared to the prior year.

Material uncertainty in the valuation of properties continued

At 30 June New Zealand valuers, consistent with their approach at 31 March and 31 May, included a material uncertainty clause in their property valuations. This clause highlighted that less certainty, and consequently a higher degree of caution, should be attached to valuations as a result of COVID-19. It was due primarily to the lack of commercial property transaction activity on which to establish a willing buyer, willing seller price (fair value).

All six companies with investment property highlighted this in their financial reporting.

It will be interesting to see whether the valuers include the same clauses in their valuations at 30 September. There are five investment property vehicles, two retirement village operators and Infratil which hold substantial investment property who will report a 30 September half year. There has been transactional activity but is it sufficient to establish fair value with more certainty? It is likely the valuers will take a sector approach given the uncertainty that remains in the retail property sector in particular.

Dividends – to pay or not to pay?

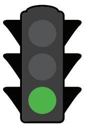
A large proportion of the June reporters did not declare a dividend. Many of them also cancelled interim dividends that had previously been announced. This confirms that the June reporters were more significantly impacted by the economic consequences of COVID-19 than the March to May reporters.

Other notable mentions identified in the financial reports

- Meridian Energy donated $1m to KidsCan as a specific response to help those facing hardship, particularly in light of COVID-19.
- Precinct Properties in the year to 30 June 2020 had provided $1.7m in rental abatements to its tenants.
- Port of Tauranga noted that in the year to 30 June 2020 16 cruise ship visits to New Zealand had been lost.
- SkyCity was hit by the devastating New Zealand International Convention Centre (NZICC) fire in October 2019. Similar to the detailed one stop shop COVID-19 note that many companies have included in their financial reporting, SkyCity has done the same for the NZICC fire impacts. The financial reporting impacts are significant and complex.
- Sky TV ($157m) and SkyCity ($180m) both completed capital raises prior to 30 June. SkyCity also raised an additional $50m subsequent to 30 June with the completion of a share purchase plan.

What was the impact on audit reports?

Earlier in this year, we used the analogy of traffic lights to indicate areas of concern and where readers of audit reports should focus their attention. The table below illustrates the outcome:

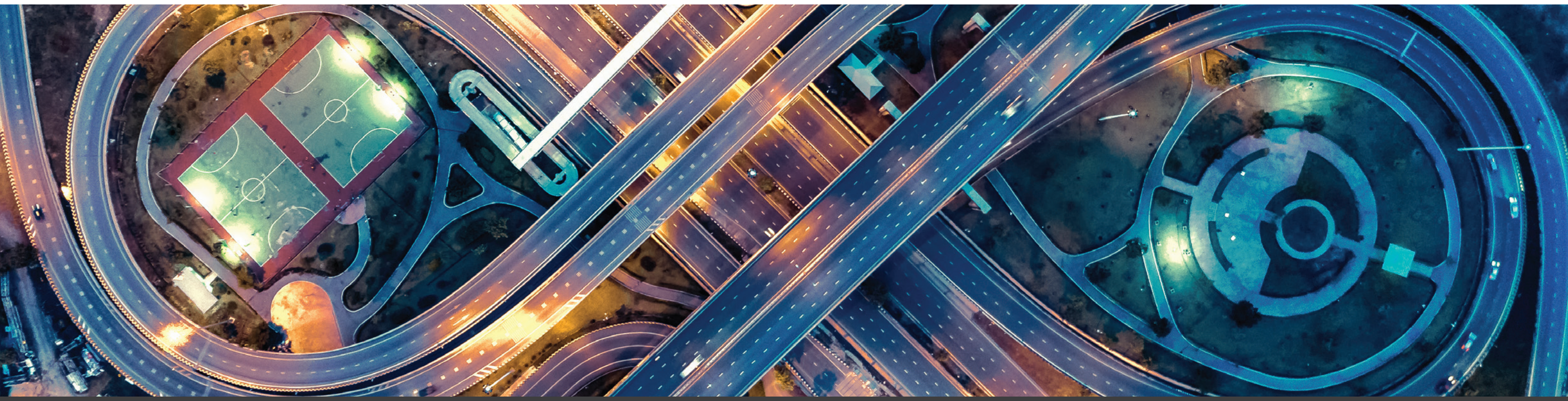
	Audit report type		
	**Clean** (the audit report does not include any areas of concern)	**22**	A number of new KAMs were included by auditors including four instances where the KAM was in respect of procedures undertaken by the auditor on the appropriateness of the use of the going concern basis of accounting.
	**Clean but with a warning** (the audit report includes some areas of concern for users of financial reports to be aware of)	**0**	None of the companies had what is called a '*material uncertainty related to going concern*' emphasis in the audit report
	**Qualified** (a report where the auditor has not had all the necessary information needed)	**0**	

What do the 'green' traffic light audit reports reveal?

All reports were required to include key audit matters (KAMs). The auditor uses KAMs to tell the story of their audit, especially where significant effort was needed. We didn't see any significant change in KAMs when we examined the March to May NZX50 reporters. However, we have seen changes in KAMs in many instances for June reporters.

As a result of COVID-19, many companies have taken steps to ensure they have the necessary financial funding and liquidity to underpin use of the going concern basis of accounting. We have noted that AIA, SkyCity and Sky TV have undertaken capital raises and Air New Zealand arranged a $900m standby facility with the Government. Many companies also agreed changes in maturity dates for debt facilities with banks and other debt providers, deferred capital expenditure, suspended dividends and resolved with lenders that covenants in debt agreements will not be tested until late in 2021.

The auditors of four companies included new KAMs in their audit reports focused on aspects of the going concern assessment whether liquidity, funding or the capital structure. If an auditor has included this in a KAM it is generally referred to as a 'close call'. The auditor has been able to obtain sufficient appropriate evidence to determine that use of the going concern basis of accounting was appropriate and there were no material uncertainties concerning its use. But, to be a KAM, the auditor has undertaken significant effort in this area. If there had been material uncertainties this would have likely resulted in the auditor including a separate section called '*material uncertainty related to going concern*' in the audit report. This would have been an orange traffic light.



Other new KAMs of note include:

- NZ IFRS 16 Leases – the impact of the adoption of this new standard was seen as significant by the auditors of two companies.
- Impairment of assets – not surprisingly this was a significant area of focus in many audit reports and was a new area not identified by the auditor previously in two companies.
- One KAM dealing with an event subsequent to balance date relating to the announcement of Rio Tinto of the planned closure of the aluminium smelter – it is not common to have a KAM that covers a subsequent event.
- The auditors of four companies included new KAMs in respect of acquisitions or divestments which required significant audit effort.
- Deferred tax, including the methodology and assumptions underpinning the determination of deferred tax, was a new KAM in one company.
- The NZICC fire and accounting for the impacts was included as a KAM in SkyCity's audit report.

Was the June reporting season unprecedented?

In short – yes. These are some of 'New Zealand's largest companies and the impact of COVID-19 has been significant. However, similar to our earlier research on the March to May reporters, the effect on financial reporting has been modest. June reporters included detailed disclosures in their financial statements making it easier for the user to appreciate and understand the greater number of difficult judgements and estimates that were made.

Auditors have added many new KAMs in their audit reports highlighting areas where significant effort was required. This included consideration of the appropriateness of using the going concern basis of accounting. The audit report is how auditors tell the story of their audit. We continue to encourage savvy investors to use audit reports to help them frame questions for Directors at Annual Shareholders meetings and, in doing so, bring greater transparency to financial reporting.

This overview follows our two earlier papers looking into the likely impact of COVID-19 on audit reports published in May 2020 and the effect of the pandemic on March to May NZX50 reporters. If you have any questions or would like to know more, please get in touch.

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