



In depth – COVID-19

A look at current financial reporting issues

26 March 2020

Accounting implications of the effects of the coronavirus

At a glance

This In depth considers the impact of the new coronavirus ('COVID-19', 'pandemia' or 'the virus') on the financial statements and interim reports for periods ending on or after 31 December 2019 of entities whose business, results and financial position are affected by the pandemia. There are broad IFRS implications, including:

- going concern;
- fixed assets, goodwill and investments;
- financial instruments and leases;
- revenue recognition;
- non-financial obligations;
- income taxes;
- disclosures: and
- interim financial statements.

Background

The COVID-19 outbreak has developed rapidly globally and in Finland during 2020, with a significant number of infections and the outbreak has been declared a public health emergency of international concern by the World Health Organization, causing significant impact to communities and businesses around the globe. Recent measures taken to contain the virus have affected economic activity, which in turn has implications for financial reporting.

Measures to prevent transmission of the virus include limiting the movement of people, all travel, closing off borders, temporarily closing businesses schools, restaurants, theaters, sport clubs and cancelling events. This will have an immediate impact on businesses such as tourism, transport, retail, service 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. Financial services entities such as banks that lend to affected entities, insurers that provide protection to affected individuals and businesses, and funds or other investors that invest in affected entities are also likely to be affected.

Companies across the globe are operating in uncertain times and facing unprecedented challenges. While ensuring that employees and staff are staying healthy is the top priority for management, management should carefully consider the impact of the COVID-19 outbreak on their financial reporting impacting the upcoming first quarter 2020 reporting as the impact could be significant for many businesses. For those companies that have not closed their 2019 year-end, the COVID-19 outbreak should be considered under post-balance sheet events.

The implications for financial statements include not only the measurement of assets and liabilities but also disclosure and possibly an entity's ability to continue as a going concern. The implications, including the indirect effects from lower economic activity, should be considered by all entities, not just those in the territories most significantly affected

Going concern

Management should consider the potential implications of the pandemic 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. Management should consider the impact of measures taken by governments and local banks in its assessment of going concern. Management should also remember that events after the reporting date that indicate an entity is no longer a going concern are always adjusting events.

Material uncertainties that might cast significant doubt upon an entity's ability to continue as a going concern should be disclosed in accordance with IAS 1.

Fixed assets, goodwill and investments

Impairment under IAS 36 Impairment of assets

Many companies will have to consider the potential impairment of intangible assets and goodwill. IAS 36 requires that goodwill and indefinite lived intangible assets are tested for impairment at a minimum every year and other non-financial assets whenever there is an indicator that those assets might be impaired. Temporarily ceasing operations or suffering an immediate decline in demand or prices and profitability are clearly events that might indicate impairment. However, the impact of reduced economic activity and lower revenues are likely to affect almost any entity and might also indicate impairment and require that impairment testing is carried out.

Management should consider whether:

- COVID-19 and the measures taken to control it are likely to reduce future cash inflows or increase operating and other costs for the reasons described above;
- these events, including for example a fall in an entity's share price such that market capitalisation is lower than carrying value, are an indicator of impairment requiring that goodwill and indefinite lived intangible assets are tested outside of the annual cycle or that other assets are tested;
- the assumptions and cash flow forecasts used to test for impairment should be updated to reflect the potential impact of COVID-19;
- budgets, forecasts and other assumptions from an earlier impairment testing date that were used to determine the recoverable amount of an asset should be revised to reflect the economic conditions at the balance sheet date, specifically to address increased risk and uncertainty;
- an expected cash flow approach (multiple probability-weighted scenarios) might be a better way to estimate recoverable amount than a single predicted outcome to capture the increased risk and uncertainty. The potential impact of measures taken to control the spread of the virus could be included as additional scenarios in an expected cash flow approach. There might be a range of potential outcomes considering different scenarios;
- the factors used to determine the discount rate, irrespective of how the recoverable amount is determined, should be revised to reflect the impact of the virus and the measures taken to control it, for example the risk free rate, country risk and asset risk. The discount rate used in a single predicted outcome approach should be adjusted to incorporate the risk associated with COVID-19. Management should ensure that appropriate risk is reflected in either the cash flows or the discount rate.

Whichever approach management chooses to reflect the expectations about possible variations in the expected future cash flows, the outcome should reflect the expected present value of the future cash flows. When fair value is used to determine the recoverable amount, the assumptions made should reflect market participant assumptions under current circumstances.

Property, plant and equipment

The pandemic might mean that property, plant and equipment is under-utilised or not utilised for a period or that capital projects are suspended. IAS 16 *Property, plant and equipment* requires that depreciation continues to be charged in the income statement while an asset is temporarily idle. IAS 23 *Borrowing costs* requires that the capitalisation of interest is suspended when development of an asset is suspended.

Disclosures

The disclosure requirements in IAS 36 are extensive. Management should consider specifically the requirements to disclose assumptions and sensitivities in the context of testing goodwill and indefinite lived intangible assets.

Management should also consider the requirements in IAS 1 *Presentation of financial statements* to disclose the major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the financial statements in a subsequent period. The disclosure of the estimation uncertainty is critical under these exceptional circumstances.

Associates and joint ventures accounted for using the equity method

Interests in joint ventures and associates accounted for under the equity method are tested for impairment in accordance with IAS 28 *Investments in Associates and Joint Ventures*. Management should consider whether the impact of COVID-19 and the measures taken to control it are an indicator that an associate or joint venture is impaired.

Interests in joint ventures and associates that are in the scope of IFRS 9 *Financial instruments* are subject to that standard's impairment guidance.

Inventories

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 commodity prices, or inventory obsolescence due to lower than expected sales.

IAS 2 *Inventories* requires that fixed production overheads are included in 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.

Entities should assess the significance of any write-downs and whether they require disclosure in accordance with IAS 2.

Financial instruments and leases

Impairment under IFRS 9 Financial instruments

Where an entity has any financial instruments that are in the scope of IFRS 9's expected credit loss model (ECL) management should consider the impact of COVID-19 on the ECL. Instruments to be considered include loans, trade and other receivables, debt instruments not measured at fair value through profit or loss, contract assets, lease receivables, financial guarantees and loan commitments

Management should consider the impact of COVID-19 on both:

- whether the ECL is measured at a 12-month or lifetime ECL. If the credit risk (risk of default) has increased significantly, since initial recognition the ECL is measured at the lifetime ECL rather than the 12-month ECL (except for assets subject to the simplified approach, such as short term receivables and contract assets, which are always measured using lifetime ECL); and
- the estimate of ECL itself. This will include all of
 - the credit risk (risk of default). For example, this may increase if the debtor's business is adversely impacted by the pandemic;
 - the amount at risk if the debtor defaults (exposure at default). For example, debtors affected by COVID-19 may draw down on existing unused borrowing facilities, or cease making discretionary over payments, or take longer than normal to pay resulting in a greater amount at risk; and

- the estimated loss as a result of default (loss given default). For example, this may increase if COVID-19 results in a decrease in the fair value of a non-financial asset pledged as collateral.

Even when a borrower is expected to repay all amounts owed but later than contractually required, there will be a credit loss if the lender is not compensated for the lost time value of money.

IFRS 9 requires that forward-looking information (including macro-economic information) is considered both when assessing whether there has been a significant increase in credit risk and when measuring expected credit losses. Forward-looking information might include additional downside scenarios related to the spread of COVID-19. This might be achieved by adding one or more additional scenarios to the entity's existing scenarios, amending one or more of the existing scenarios (for example, to reflect a more severe downside(s) and/or to increase their weighting), or using an 'overlay' if the impact is not included in the entity's main expected credit loss model.

Certain governments might ask local banks to support borrowers affected by COVID-19. This could be in the form of payment holidays on existing loans or reduced fees and interest rates on new loans. Entities giving such support should consider the impact on their financial statements including whether:

- payment holidays indicate the affected loans have suffered a significant increase in credit risk or default, and therefore moved to stage 2 or 3 of the ECL model; and
- reduced fees or interest rates on new loans indicate that the loans are not made at a market rate, in which case their initial fair value shall be assessed.
- whether the terms of the new loans, for example payment holidays during which interest is not accrued, impacts the classification of the cash flow characteristics of the loan so that it shall be classified as at fair value through profit or loss instead of at amortised cost.

Management should consider the need to disclose the impact of the pandemic on the impairment of financial assets. For example, disclosures required by IFRS 7 *Financial instruments: Disclosures* that might be affected include how the impact of forward looking information has been incorporated into the ECL estimate, details of significant changes in assumptions made in the reporting period, and changes in the ECL that result from assets moving from stage 1 to stage 2.

Contingent consideration

Contingent consideration in a business combination is often based on the future profitability of the acquired business. The acquirer measures the contingent consideration at fair value at the acquisition date and also at subsequent reporting dates. The changes in the fair value of the contingent consideration after the acquisition date are recognised in the income statement.

The impact of COVID-19 and the measures taken to control the spreading of the virus may significantly weaken the future profitability of acquired businesses. Therefore, management should consider whether changes are required on the fair value of any contingent consideration liabilities as a result.

Other measurement issues relevant to financial instruments

Fair value

The fair value of an asset or liability at the reporting date should be determined in accordance with the applicable IFRS standards. In accordance with IFRS 13 *Fair Value Measurement*, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When fair value is based on an observable market price (i.e. is in Level 1 in the fair value hierarchy), the quoted price at the reporting date should be used. When the fair value measurement is based on unobservable inputs (i.e. based on Level 3 measurements), the management should use judgement to determine that the unobservable inputs reflect how market participants would take the effect of COVID-19 into account in the fair value measurement.

The volatility of prices on various markets has increased as a result of the spread of COVID-19. This affects the fair value measurement either directly - if fair value is determined based on market prices (for example, in case of shares or debt securities traded on an active market), or indirectly - for example, if a valuation technique is based on inputs that are derived from volatile markets.

Counterparty credit risk and the credit spread that is used to determine fair value might also increase because of the impacts of the pandemic. On the other hand, the impact of actions taken by governments to stimulate the economy might reduce risk free interest rates.

Changes in market prices after the reporting date (measurement date) are, however, not reflected in asset valuation, because they do not reflect the circumstances at the reporting date.

All these changes in the fair value measurement affect the disclosures required by IFRS 13, which requires entities, among others, to describe the valuation techniques and the inputs used in the fair value measurement as well as the sensitivity of the valuation to changes in assumptions. It might also affect the sensitivity analysis required for recurring fair value measurements categorised within level 3 of the fair value hierarchy. The number of instruments classified as level 3 might increase.

Other financial instrument measurement issues

Management should consider the impact of the changes to the terms of any borrowing or loan agreement, perhaps because of actions taken by the local government or the renegotiation of terms between a borrower and a lender. Both parties should apply the guidance in IFRS 9 to determine the impact of the change in terms including those for determining whether the change to the terms results in derecognition and, if not, for recognising a modification gain or loss.

Management should also assess whether the entity continues to meet the criteria for hedge accounting. For example, if a hedged forecast transaction is no longer highly probable to occur, hedge accounting is discontinued prospectively. If the cash flows are not expected at all, reserves accumulated in the cash flow hedge reserve must be immediately released to P/L.

Additional disclosures might also be required. For example, IFRS 7 requires disclosure of defaults and breaches of loans payable, of gains and losses arising from derecognition or modification, and of any reclassification from the cash flow hedge reserve that results from hedged future cash flows no longer being expected to occur.

Breach of covenants

The financial impact of the pandemic might cause some entities to breach covenants on borrowings or trigger material adverse change clauses. This could result in loan repayment terms changing and some loans becoming repayable on demand. Management should consider whether the classification of loans and other financing liabilities between noncurrent and current is affected and in extreme situations whether the entity remains a going concern. Management should consider particularly the impact of any cross-default clauses. Management should also consider the effect of any changes in the terms of borrowings as a result of the circumstances before the end of the reporting period as described above. If the change is made or a waiver obtained after the reporting date that is treated as non-adjusting event and disclosed. Obtaining a waiver post-balance sheet date for a covenant breach may require the classification of the loans as short-term on the balance sheet.

Leases

A lessor and a lessee might renegotiate the terms of a lease as a result of COVID-19 or a lessor might grant a lessee a concession of some sort in connection with lease payments. In some cases, a lessor might receive compensation from a local government as an incentive to offer such concessions. Both lessors and lessees should consider the requirements of IFRS 16 *Leases* and whether the concession should be accounted for a lease modification and spread over the remaining period of the lease. Lessors and lessees should also consider whether incentives received from a local government are government grants, which should be accounted for in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

Subsidiaries, associates, joint ventures and investment properties measured at fair value

The fair values of investments in subsidiaries, associates and joint ventures might be affected by equity market volatility. The starting point for valuations of listed companies is the market price at the reporting date.

Investment property valuations could also be affected.

Entities are required to disclose changes in business or economic circumstances that affect the fair value of investment properties or investments in associates and joint ventures carried at fair value under IFRS 9.

Revenue recognition

An entity's sales and revenue might decline as a result of the reduced economic activity following the steps taken to control the virus. This is accounted for on the basis of actual sales.

However, there could also be an effect on the assumptions made by management in measuring the revenue from goods or services already delivered and in particular on the measurement of variable consideration. For example, reduced demand could lead to an increase in expected returns, additional price concessions, reduced volume discounts, penalties for late delivery or a reduction in the prices that can be obtained by a customer. All of these could affect the measurement of variable consideration. IFRS 15 *Revenue from contracts with customers* requires that variable consideration is recognised only when it is highly probable that amounts recognised will not be reversed when the uncertainty is resolved.

Management should reconsider both its estimate of variable consideration and whether the recognition threshold is met.

IFRS 15 is applied only to those contracts where management expects its customer to meet its obligations as they fall due. Management might choose to continue to supply a customer even when it is aware that the customer might not be able to pay for some or all the goods being supplied. Revenue is recognised in these circumstances only when it is probable that the customer will pay the transaction price when it is due net of any price concession.

IFRS 15 requires that an entity disclose information that allows users to understand the nature, amount, timing and uncertainty of cash flows arising from revenue. This might require for example, information about how an entity has applied its policies taking into account the uncertainty that arises from the pandemic, the significant judgments applied, for example whether a customer is able to pay, and the significant estimates made, for example in connection with variable consideration.

Government assistance

Governments around the world have reacted to the impact of COVID-19 with a variety of measures, including tax rebates and holidays and, in some cases, specific support for businesses in order that those businesses are able to support their customers. Management should consider whether this type of assistance received from a government meets the definition of a government grant in IAS 20 *Government grants*. The guidance in IAS 20 should be applied to a government grant.

Non financial obligations

Provisions

IAS 37 *Provisions, contingent liabilities and contingent assets*, requires a provision to be recognised only where an entity has a present obligation; it is probable that an outflow of resources is required to settle the obligation; and a reliable estimate can be made. Management's actions in relation to the pandemic should be accounted for as a provision only to the extent that there is a present obligation for which the outflow of economic benefits is probable and can be reliably estimated. For example, a provision for restructuring should be recognised only when there is a detailed formal plan for the restructuring and management has raised a valid expectation in those affected that the plan will be implemented.

IAS 37 does not permit provisions for future operating costs or future business recovery costs.

IAS 37 requires that an entity disclose the nature of the obligation and the expected timing of the outflow of economic benefits.

Onerous contracts

Onerous contracts are those contracts for which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Unavoidable costs under a contract are the least net cost of exiting the contract (that is, the lower of the cost to exit or breach the contract and the cost of fulfilling it). Such contracts might include, for example, supply contracts that the entity is not able to fulfil because of the virus. Management should consider whether any of its contracts have become onerous.

Contingent assets

One of the steps taken to control the spread of the virus is to require that some businesses close down temporarily. An entity might have business continuity insurance and be able to recover some or all of the costs of closing down. Management should consider whether the losses arising from the pandemic are covered by its insurance policies. The benefit of such insurance is recognised when the recovery is virtually certain. This is typically when the insurer has

accepted that there is a valid claim and management is satisfied that the insurer can meet its obligations. The benefit of insurance is often recognised later than the costs for which it compensates.

Employee benefits and share-based payments

Management should consider whether any of the assumptions used to measure employee benefits and share based payments should be revised. For example, the yield on high-quality bonds or the risk-free interest rate in a particular currency might have changed as a result of recent developments or the probability of an employee meeting the vesting conditions for bonuses or share based payments might have changed.

Management should consider the impact of any changes made to the terms of, for example, a share-based payment plan, to address the changes in the economic environment and the likelihood that performance conditions will be met. To the extent that such changes are beneficial to the employee, they would be accounted for as a modification and an additional expense recognised. Management should be aware that cancelling an equity-settled share based payment award even if the vesting conditions are unlikely to be satisfied results in the immediate recognition of the remaining expense.

Management should also consider whether it has a legal or constructive obligation to its employees in connection with the pandemic, for example sick pay or payments to employees that self-isolate (and are not able to work remote), for which a liability should be recognised.

Management might be considering laying staff off temporarily or reducing its work-force as a result of the virus. IAS 19 *Employee benefits* requires that a liability for employee termination is recognised only when the entity can no longer withdraw the offer of those benefits or the costs of a related restructuring are recognised in accordance with IAS 37. IFRS 2 *Share based payment* requires that entities explain modifications to share based payments, along with the incremental fair value granted, as well as information about how the incremental fair value was determined.

IAS 19 requires extensive disclosure of the assumptions used to estimate employee benefit liabilities, together with sensitivities and changes in those assumptions.

Income taxes

The virus could affect future profits as a result of direct and indirect (effect on customers, suppliers, service providers) factors. Asset impairment may also reduce the amount of deferred tax liabilities and/or create additional deductible temporary differences. Entities with deferred tax assets should reassess forecast profits and the recoverability of deferred tax assets in accordance with IAS 12 *Income taxes* taking into account the additional uncertainty arising from the virus and the steps taken to control it.

Management might also consider whether the impact of the pandemic affects its plans to distribute profits from subsidiaries and whether it therefore needs to reconsider the recognition of any deferred tax liability in connection with undistributed profits.

Management should disclose any significant judgements and estimates made in assessing the recoverability of deferred tax assets, in accordance with IAS 1.

Disclosures including financial risk

Events after the reporting period

The global situation is evolving rapidly. Management should therefore consider the requirements of IAS 10 *Events after the reporting period* and in particular whether the latest developments provide more information about the circumstances that existed at the reporting date. Events that provide more information about the spread of the virus and the related costs might be adjusting events. Events, such as the announcement or enactment of new measures to contain the virus or decisions taken by management are likely to be non-adjusting. Clear disclosure of nonadjusting events is required when this is material to the financial statements.

General disclosures

Management should consider the specific requirements in IAS 1 to disclose significant accounting policies, the most significant judgements made in applying those accounting policies. According to IAS 1, entities should also disclose

information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

All of these disclosures might be different as a result of the impact of the pandemic on the entity's business. The extent of disclosures regarding estimation uncertainty might need to be increased considering current market conditions. For example, the carrying amount of more items might be subject to a material change within the next year.

There might be individually significant financial effects of the pandemic, for example, individually material expenses such as impairments and write-downs, onerous contracts or a modification adjustment. In addition to the disclosure requirements of individual standards, IAS 1 requires that an entity discloses separately on the face of the income statement or in the notes to the financial statements material items of income or expense. The management should also consider the need to disclose additional line items or sub-totals on the face of the income statement where this is necessary for an understanding of performance. Management should consider the specific requirements of IAS 1 if it discloses additional sub-totals. In addition, there is also a requirement in IAS 1 to disclose information relevant to an understanding of the financial statements that is not otherwise disclosed.

Financial risks

Financial risks comprise of credit risk, liquidity risk and market risk (currency risk, interest rate risk and other price risk). Entities will need to disclose any changes in their financial risks or in their risk management objectives, policies and processes. The changes caused by the pandemic should be disclosed in the risk management disclosures.

In particular additional disclosures about liquidity risk might be needed where the pandemic has affected an entity's normal levels of cash inflows from operations or its ability to access cash in other ways such as from factoring receivables or supplier finance. Disclosures should transparently reflect if the entity has challenges in meeting the obligations presented in the maturity table.

The impacts of the pandemic on the entity's customers may show as increased credit risk, which impacts the determination of ECL as described above. Disclosure requirements of credit risk and credit risk management are to be considered in point of view of completeness and changes due to the virus. In particular, management judgement applied is to be described and sensitivity analyses for different scenarios may need to be added. Volatility of markets may impact also disclosures related to market risks such as sensitivity analyses.

Disclosure outside the financial statements

An entity's stakeholders will be interested in the impact of the pandemic and the measures taken to contain its spread. Some of these stakeholder's needs might be met more appropriately by disclosure outside the financial statements. Management might consider updating its analysis of the principal risk factors and uncertainties. Management should also consider any specific local disclosure requirements, for example, those issued by a local securities regulator. For example, ESMA has recently stated that: "issuers should provide transparency on the actual and potential impacts of COVID-19, to the extent possible based on both a qualitative and quantitative assessment on their business activities, financial situation and economic performance in their 2019 year-end financial report if these have not yet been finalised or otherwise in their interim financial reporting disclosures." Further, requirements of Limited Liability Companies Act (OYL) and Securities Markets Act (AML) in addition to disclosure obligation under Stock Exchange Rules are to be considered.

Interim financial statements

Many entities may first report the impact of the pandemic in their interim financial statements. The recognition and measurement guidance described above applies equally to interim financial statements. There are typically no recognition or measurement exceptions for interim reporting, although management might have to consider whether the impact of the pandemic is a discrete event for the purposes of calculating the expected effective tax rate. IAS 34 *Interim financial statements* states that there might be greater use of estimates in interim financial statements, but it requires that the information is reliable and that all relevant information is disclosed.

Interim financial information usually updates the information in the annual financial statements. However, IAS 34 requires that an entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. This implies that additional disclosure should be given to reflect the financial impact of the

pandemia and the measures taken to contain it. This disclosure should be entity specific and should reflect each entity's circumstances.

Where significant, the disclosures required by paragraph 15B in IAS 34 should be included, together with:

- the impact of the pandemia on the results, balance sheet and cash flows and the steps taken to control the spread;
- significant judgements that were not required previously, for example in connection with expected credit losses;
- updates to the disclosures of significant estimates; and
- events since the end of the interim period.

Authored by:

Netta Mikkilä

Partner

Email: netta.mikkila@pwc.com

Timo Ihamäki

Partner

Email timo.ihamaki@pwc.com

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2020 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.