In depth

A look at current financial reporting issues

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Accounting implications of the effects of coronavirus

At a glance

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

- non-financial assets;
- financial instruments;
- leases;
- cash and cash equivalents
- revenue recognition;
- non-financial obligations;
- going concern;
- disclosures; and
- interim financial

Refer here for frequently asked questions related to the accounting implications of the effects of COVID-19.

Background

The COVID-19 outbreak has developed rapidly in 2020, with a significant number of infections. Measures taken to contain the virus have affected economic activity, which in turn have implications for financial reporting.

Measures to prevent transmission of the virus include limiting the movement of people, restricting flights and other travel, temporarily closing businesses and schools, and cancelling events. This will have an immediate impact on businesses such as tourism, transport, retail and entertainment. It will also begin to affect supply chains and the production of goods throughout the world, and lower economic activity is likely to result in reduced demand for many goods and services. 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.

Management should carefully consider the impact of COVID-19 on both interim and annual financial statements. The impact could be significant for many businesses.

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.

Non-financial assets

Impairment under IAS 36, 'Impairment of assets'

Many businesses will have to consider the potential impairment of non-financial assets. IAS 36 requires goodwill and indefinite-lived intangible assets to be tested for impairment at a minimum every year, and other non-financial assets whenever there is an indicator 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, reduced economic activity and lower revenues are likely to affect almost any entity and might also indicate impairment.

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 carry value) are an indicator of impairment requiring goodwill and indefinite-lived intangible assets to be tested outside the annual cycle or other assets to be 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, however 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. Where fair value is used to determine the recoverable amount, the assumptions made should reflect market participant assumptions.

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.

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 within the scope of IFRS 9, 'Financial instruments', are subject to that standard's impairment guidance.

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 fixed production overheads to be 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.

Property, plant and equipment

The virus might mean 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 depreciation to continue to be charged in the income statement while an asset is temporarily idle. IAS 23, 'Borrowing costs', requires the capitalisation of interest to be suspended when development of an asset is suspended.

Fair value measurement of non-financial assets and liabilities (including investment properties)

Fair values are likely to change significantly as a result of COVID-19.

Valuation best practices support the use of multiple valuation techniques when estimating the fair values. Changing methodologies (for example, from a market multiple approach to a discounted cash flow approach), or changing the weighting where multiple valuation techniques are used, would be appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. This change would be considered a change in accounting estimate.

The discount rate used in a discounted cash flow technique includes a number of market inputs, including a risk-free rate and a cost of debt. In most jurisdictions, risk-free rates have declined significantly in 2020, while the cost of debt has declined for some entities and increased for others. This could result, for some entities, in a lower weighted average cost of capital, and thus discount rate. However, entities should remember that the discount rate needs to be calibrated to the risks in the cash flow forecast, including the long-term growth rate.

Please also refer to fair value measurements of financial instruments under IFRS 13.

Financial instruments

Classification and measurement of financial assets under IFRS 9

Under IFRS 9, the classification of financial assets that are debt instruments depends on both (a) the entity's business model for managing the financial assets, and (b) whether the contractual cash flows of the financial asset are solely payments of principal and interest.

Management should consider the impact of COVID-19 on the classification of these assets, in particular whether the entity's business model for managing financial assets might have changed.

Additionally, the impact of any changes to the terms of a loan agreement, perhaps because of actions taken by local government or the renegotiation of terms between a borrower and a lender, should be assessed. Lenders 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.

Impairment under IFRS 9

Where an entity has any financial instruments that are within the scope of IFRS 9's expected credit loss (ECL) model, 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 of the following:

- 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 might increase if the debtor's business is adversely impacted by COVID-19;
    - the amount at risk if the debtor defaults (exposure at default); for example, debtors affected by COVID-19 might 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 might increase if COVID-19 results in a decrease in the fair value of a non-financial asset pledged as collateral.

Even where 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 forward-looking information (including macro-economic information) to be considered both when assessing whether there has been a significant increase in credit risk and when measuring ECL. 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 ECL 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 that the affected loans have suffered a significant increase in credit risk or default, and therefore moved to stage 2 or stage 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.

Management should consider the need to disclose the impact of the virus 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.

Hedge accounting under IFRS 9

Management should consider the impact of COVID-19 on its existing hedges, in particular whether the hedges continue 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. For similar reasons, management should also consider the impact of COVID-19 on its ability to designate new hedges.

Hedge accounting under IAS 39, 'Financial instruments'

Management should consider the impact of COVID-19 on its existing hedges, in particular whether hedges continue to meet the criteria for hedge accounting. For example, if a hedged forecast transaction is no longer highly probable to occur or no longer highly effective, hedge accounting is discontinued. For similar reasons, management should also consider the impact of COVID-19 on its ability to designate new hedges.

Borrowings and other financial liabilities under IFRS 9

The impact of any changes to the terms of a loan agreement, perhaps because of actions taken by local government or the renegotiation of terms with the lender, should be assessed. Borrowers 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.

'Own use' under IFRS 9

Under IFRS 9, contracts to buy or sell a non-financial item that can be settled net in cash are within the scope of the standards (with the result that they are typically accounted for as derivatives), unless the contracts were entered into and continue to be held for the purpose of receipt or delivery of non-financial items to meet the entity's expected purchase, sale or usage requirements. COVID-19 might impact whether some contracts meet these 'own use' requirements. For example, disruption to an entity's supply chain due to COVID-19 might have the effect that certain commodity contracts will be settled net in cash rather than by physical delivery.

Disclosures under IFRS 7

Additional disclosures might be required. IFRS 7 requires, amongst other things, 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.

Fair value of financial assets and liabilities

The fair value of an asset or liability at the reporting date should be determined in accordance with the applicable IFRS standards. Where fair value is based on an observable market price, the quoted price at the reporting date should be used. The fair value of an asset reflects a hypothetical exit transaction at the reporting date. Changes in market prices after the reporting date are therefore not reflected in asset valuation.

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 the 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. However, the impact of actions taken by governments to stimulate the economy might reduce risk-free interest rates.

A change in the fair value measurement affects the disclosures required by IFRS 13, 'Fair value measurement', which requires entities to disclose 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.

Subsidiaries, associates and joint ventures 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 prices at the reporting date.

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

Classification and measurement of financial assets under IAS 39 (applicable to insurers applying the temporary exemption from IFRS 9)

Financial assets are classified in one of four categories under IAS 39. Reclassifications between categories could be considered by management as a result of COVID-19. The guidance in IAS 39 should be followed to determine whether reclassification is permitted or required.

Impairment of financial assets under IAS 39 (applicable to insurers applying the temporary exemption from IFRS 9)

Impairment charges will likely increase as a result of COVID-19. Under IAS 39, a financial asset is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the asset's initial recognition (a 'loss event'). For investments in equity securities, a 'significant' or 'prolonged' decline in the fair value below cost is one example of objective evidence of impairment.

Borrowings and other financial liabilities under IAS 39 (applicable to insurers applying the temporary exemption from IFRS 9)

The contractual terms of an entity's borrowings or other payables could be amended as a result of COVID-19. Management should determine whether the change in terms results in derecognition or is accounted for as a modification.

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 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 as a lease modification and spread over the remaining period of the lease. Lessors and lessees should also consider whether incentives received from local government are government grants.

Cash and cash equivalents

IAS 7 defines cash equivalents as short-term highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. COVID-19 has resulted in the value of some money market and other funds declining more than insignificantly. Furthermore, some money market funds include clauses which allow the fund manager to restrict redemption in unlikely events, one of which might be the result of COVID-19. Management should consider whether investments previously classified as cash equivalents continue to meet the definition in light of these declines in value and/or restrictions on redemption. Investments might need to be re-classified out of cash equivalents.

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 when it happens.

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

IFRS 15 requires an entity to 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 virus, the significant judgements 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 virus 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 where 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 an entity to 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 unable 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 some businesses to close temporarily. An entity might have business continuity insurance and be able to recover some or all of the costs of closing. Management should consider whether the losses arising from COVID-19 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 would be recognised. Management should be aware that cancelling a share-based payment award, even if the vesting conditions are unlikely to be satisfied, results in 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 virus (for example, sick pay or payments to employees that self-isolate) for which a liability should be recognised in accordance with the guidance in IAS 19, 'Employee benefits'.

Management might be considering reducing its workforce as a result of the virus. IAS 19 requires a liability for employee termination to be 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 entities to explain modifications to share-based payments, 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 factors (including effect on customers, suppliers and service providers). Asset impairment could 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 virus affects its plans to distribute profits from subsidiaries and, therefore, whether it 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.

Breach of covenants

The financial impact of the virus might cause some entities to breach covenants on borrowings, or it might 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 non-current 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 described above, and it should treat waivers obtained after the reporting date as non-adjusting events.

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. Clear disclosure of adjustments made and events that are considered to be non-adjusting is required where this is material to the financial statements.

Going concern

Management should consider the potential implications of COVID-19 and the measures taken to control it when assessing the entity's ability to continue as a going concern. An entity is no longer a going concern if management intends either to liquidate the entity or to cease trading, or it 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 that an entity is no longer a going concern are always adjusting events.

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

Disclosures including financial risk

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, and the estimates that are most likely to result in an adjustment to profits in future periods. All these disclosures might be different as a result of the impact of the virus. The extent of disclosures regarding estimation uncertainty might need to be increased. 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 virus – for example, individually material expenses such as an impairment or a modification adjustment. In addition to the disclosure requirements of individual standards, IAS 1 requires an entity to disclose separately on the face of the income statement, or in the notes to the financial statements, material items of income or expense. An entity might also 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. 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

Entities will need to disclose any changes in their financial risks (such as credit risk, liquidity risk, currency risk and other price risk) or in their objectives, policies and processes for managing those risks. In particular, additional disclosures about liquidity risk might be needed where the virus 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.

Disclosure outside the financial statements

An entity's stakeholders will be interested in the impact of the virus and the measures taken to contain its spread. Some of these stakeholders' needs might be met more appropriately by disclosure outside the financial statements. Management might consider updating its analysis of the principal risks and uncertainties. Management should also consider any specific local disclosure requirements, such as those issued by a local securities regulator. For example, the European Securities and Markets Authority 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"*.

Interim financial statements

Many entities might first report the impact of the virus in 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 virus 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 the information to be reliable and all relevant information to be disclosed.

Interim financial information usually updates the information in the annual financial statements. However, IAS 34 requires an entity to 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 virus 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 of IAS 34 should be included, together with:

- the impact on the results, balance sheet and cash flows of the virus 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.

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