IFRS in Focus

Accounting Considerations Related to Coronavirus Disease 2019

Contents

The purpose of this publication is to highlight some of the key issues to be considered by entities in preparing their financial statements applying IFRS Standards for periods ending on or after 31 December 2019. It does not address management or risk reporting that without a doubt will also need to be considered.

Introduction

Global responses to the coronavirus disease 2019 (COVID-19) outbreak continue to rapidly evolve. COVID-19 has already had a significant impact on global financial markets, and it may have accounting implications for many entities.

Some of the key impacts include, but are not limited to:

- Interruptions of production.
- Supply chain disruptions.
- Unavailability of personnel.
- Reductions in sales, earnings, or productivity.
- Closure of facilities and stores.
- Delays in planned business expansions.
- Inability to raise financing.
- Increased volatility in the value of financial instruments.
- Reduced tourism, disruptions in nonessential travel and sports, cultural and other leisure activities.

In addition, entities should consider the increasingly broad effects of COVID-19 as a result of its negative impact on the global economy and major financial markets.

Entities must carefully consider their unique circumstances and risk exposures when analysing how recent events may affect their financial reporting. Specifically, financial reporting and related financial statement disclosures need to convey all material effects of COVID-19.

Accounting Considerations

As COVID-19 continues to spread globally, it may be appropriate for entities to consider the impact of the outbreak on accounting conclusions and disclosures related to, but not limited to, the following:

- Impairment of non-financial assets (including goodwill).
- Valuation of inventories.
- Allowance for expected credit losses.
- Fair value measurements.
- Onerous contracts provisions.

- Restructuring plans.
- Breach of loan covenants (including impact on the classification of liabilities as current vs non-current).
- Going concern.
- Liquidity risk management.
- Events after the end of the reporting period.
- Hedging relationships.
- Insurance recoveries related to business interruptions.
- Employment termination benefits.
- Share-based compensation performance conditions and modifications.
- Contingent consideration in contractual arrangements.
- Modifications of contractual arrangements.
- Tax considerations (in particular, recoverability of deferred tax assets).

The ultimate recognition of accounting impacts related to these issues will vary depending on each entity's specific facts and circumstances. However, the following accounting areas may be more likely to be affected as a result of the COVID-19 outbreak.

Material judgements and uncertainties

When reporting in uncertain times, it is particularly important to provide users of the financial statements with appropriate insight into the risks and uncertainties facing an entity and the judgements that have been made in preparing financial information.

Depending on an entity's specific circumstances, each of the areas discussed in this publication may be a source of material judgements and uncertainties that requires disclosure applying IAS 1 *Presentation of Financial Statements*. Where this is the case, the entity should provide disclosures, distinguishing between

- Significant judgements (disclosure required by IAS 1:122), i.e. judgements other than estimations made in applying an entity's accounting policies, often in how an item is characterised; and
- Significant sources of estimation uncertainty (disclosure required by IAS 1:125 if the source of estimation uncertainty results in a significant risk of material adjustment to assets or liabilities within the next financial year), i.e. assumptions or other sources of estimation uncertainty (including judgement involving estimation), primarily over the value of an item.

A Deloitte *IFRS in Focus* publication provides more detail on the disclosure of significant judgements and sources of estimation uncertainty.

Impairment of non-financial assets (including goodwill)

Entities may need to assess whether the impact of COVID-19 has led to an asset impairment. Their financial performance, including estimates of future cash flows and earnings, may be significantly affected by the direct or indirect impacts of recent and ongoing events. IAS 36 Impairment of Assets requires entities to perform an impairment test (i.e., estimate the recoverable amount of the affected cash generating unit) at the end of each reporting period when there is any indication that the cash generating unit may be impaired. Indicators of impairment include (but are not limited to) significant changes with an adverse effect on the entity that have taken place during the period, or will take place in the near future in the

- Market or economic environment in which the entity operates; and
- Extent to which, or the manner in which, an asset is used or is expected to be used (for example, an asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date)

As a result of the impact of COVID-19, certain entities may need to perform an impairment assessment of assets (in addition to the requirement to perform an impairment test at least annually of goodwill and intangible assets with an indefinite useful life).

Valuation of inventories

Inventories are measured at the lower of their cost and net realisable value (NRV). In a difficult economic environment, the NRV calculation may warrant additional challenge and scrutiny at the reporting date.

Also, if an entity's production level is abnormally low (for example, as a result of temporary shutdown of the production lines), it may need to review its costing of inventories to ensure that unallocated fixed overheads are recognised in profit or loss in the period in which they are incurred.

Allowance for expected credit losses (ECL)

COVID-19 can impact the ability of borrowers, whether corporate or individuals, to meet their obligations under loan relationships. Individual and corporate borrowers may have a particular exposure to the economic impacts in their geography and industry sector. More broadly, reductions in forecasts in economic growth increase the probability of default across many borrowers and loss given default rates may increase due to the fall in value of collateral evident more generally by falls in prices of assets.

Applying IFRS 9 *Financial Instruments*, an entity should measure ECL in a way that reflects

- An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- The time value of money; and
- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

ECL applies to trade receivables, loans, debt securities, as well as the losses recognised in measuring loan commitments and financial guarantee contracts.

The amount and timing of the expected credit losses as well as the probability assigned thereto must be based on reasonable and supportable information that is available without undue cost and effort at the end of the reporting period without the use of hindsight. In some cases, this may require significant judgement.

Fair value measurements

Fair value measurements (such as those involved in measuring, for example, certain financial instruments and investment properties) should reflect market participant views and market data at the measurement date under current market conditions. Entities will need to pay particular attention to fair value measurements based on unobservable inputs (sometimes referred to as level 3 measurements) and ensure that the unobservable input used reflect how market participants would reflect the effect of COVID-19, if any, in their expectations of future cash flows related to the asset or liability at the reporting date.

Onerous contracts provisions

An onerous contract arises when the unavoidable costs of meeting the obligations under the contract exceed the benefits expected to be received. Examples of contracts for which an onerous contract provision may be required include

- Revenue contracts containing penalties for late or non-delivery.
- Increased costs of fulfilling a customer contract due to the replacement of staff who are infected, subject to quarantine or are otherwise restricted from travel; or having to purchase alternative raw materials at a higher price.
- Contracts for delivery of services in the education or tourism sectors which oblige entities to provide services to smaller groups than is economically viable.

Restructuring plans

In a difficult economic environment and facing difficulties in obtaining financing, an entity may be considering or implementing restructuring plans such as the sale or closure of part of its businesses or the downsizing (temporarily or permanently) of operations. Plans such as these may require consideration of a number of issues, including whether

- The entity has a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. If and only if both of these criteria are met should a restructuring provision be recognised; and
- Any part of the business is available for immediate sale in its present condition and completion of such a sale within one year is highly probable. If so, the assets and liabilities to be disposed of are classified as held for sale and written down to their fair value less costs to sell if this is lower than their carrying amount.

Breach of covenants

Unstable trading conditions and shortages of cash flows in the affected regions may increase the risk that entities breach financial covenants. Entities should consider how the breach of a loan covenant would affect the timing of repayment of the related loan and other liabilities (e.g. it becomes repayable on demand) and how it affects the classification of the related liabilities at the reporting date.

If a breach occurs on or before the end of the reporting date and the breach provides the lender with the right to demand repayment within 12 months of the reporting date, the liability should be classified as current in the entity's financial statements in the absence of any agreements made prior to the reporting date that give the entity a right to defer payment beyond 12 months after the reporting date.

In contrast, a breach of loan covenants after the reporting date is a non-adjusting event that should be disclosed in the financial statements if the information is material. A breach after the reporting date could also affect the entity's ability to continue as a going concern.

Going concern

Financial statements are prepared on a going concern basis unless management intends either to liquidate the entity or to cease trading, or has no realistic alternative but to do so. The assessment as to whether the going concern basis is appropriate takes into account events after the end of the reporting period. For example, for 31 December 2019 reporters that are severely affected by COVID-19, even though the significant impact on operations occurred after year-end, it will be necessary for management to consider the appropriateness of preparing financial statements on a going concern basis. When management is aware of material uncertainties that cast a significant doubt on the entity's ability to continue as a going concern, the entity should disclose those material uncertainties in the financial statements.

Liquidity risk management

Disruptions in productivity and reduced sales can have implications on an entity's working capital. Entities may look to ways to manage this risk, including the use of alternative sources of funding, such as later payment to suppliers and arrangements with financial institutions such as supplier finance and reverse factoring which may permit the entity to draw down on finance in exchange for the financial institution paying the entity's suppliers. Similarly, entities may look to obtain early settlement of their trade receivables via a financial institution buying the receivables at a discounted amount to the invoice amount.

Entities should consider how the use of working capital techniques such as these are reflected in the entity's disclosure of its liquidity risk management as required by IFRS 7 Financial Instruments: Disclosures. Entities should also consider the specific disclosures requirements for transfers of financial assets as required by IFRS 7 in the case where financial assets are sold to fund working capital needs, and the accounting policies and judgements applied in determining the balance sheet and cash flow statement presentation of amounts due and paid where supplier finance and reverse factoring arrangements are used.

Events after the end of the reporting period

At the end of each reporting period, entities should carefully evaluate information that becomes available after the reporting date but before the issuance of the financial statements. The amounts in the financial statements must be adjusted to reflect events that provide evidence of conditions that existed at the end of the reporting period. Additionally, if non-adjusting events (those that are indicative of conditions that arose after the reporting period) are material, an entity would be expected to disclose the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made.

With respect to reporting periods ending on or before 31 December 2019, it is generally appropriate to consider that the effects on an entity are the result of events that arose after the reporting date (eg, decisions made in response to the COVID-19 outbreak) that may require disclosure in the financial statements but would not affect that amounts recognised.

For subsequent reporting periods, COVID-19 may affect the recognition and measurement of assets and liabilities in the financial statements.

Other potential impacts

There is a number of other areas in the financial statements that might be affected by the COVID-19, including:

- Derivative and hedging considerations, e.g. hedge accounting requirements in respect of derivatives for which the expected transaction is no longer highly probable or expected to occur.
- Insurance claims, e.g. whether it is virtually certain that amounts are receivable under business interruption and/or other insurance and the potential disclosure of contingent assets.
- Appropriate recognition of employee termination benefits resulting from a workforce reduction, e.g. as a result of closure or reorganisation of operations.
- Probability of meeting performance vesting conditions under share-based payment arrangements and the appropriate accounting for modifications or settlements of such arrangements.
- Probability of meeting performance targets in business combination arrangements, rebate arrangements with customers or suppliers, variable considerations, commission accruals.
- Appropriate accounting for modification of contractual arrangements, for example a reduction or deferral of lease payments granted by a lessor to a lessee.
- Tax considerations, e.g. impact of reduced flow of goods and services on transfer pricing agreements; recoverability of deferred tax assets.

Ongoing Considerations

Looking ahead, the impact of COVID-19 on the global economy and financial markets is expected to continue to evolve. Entities should evaluate the related accounting issues and disclosure considerations discussed above as facts and circumstances change.

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