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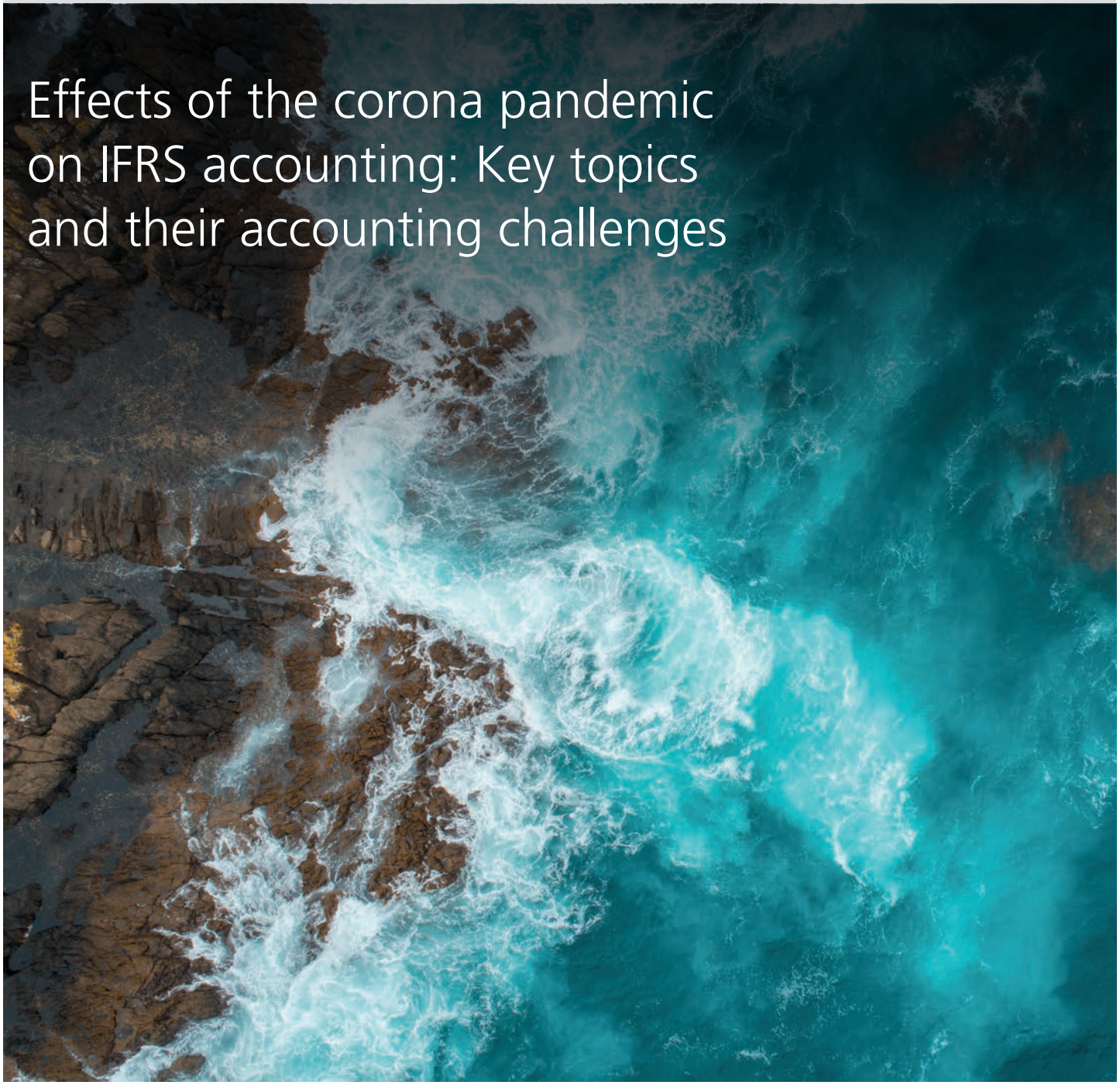
Effects of the corona pandemic on IFRS accounting: Key topics and their accounting challenges



Foreword

Dear reader,

the outbreak and worldwide spread of the new Corona virus (SARS-CoV-2), which can trigger the lung disease COVID-19, has put society and economy into a state of emergency.

This also results in consequences for companies reporting according to IFRS. Especially the current uncertainty about the extent and duration of the effects of the corona pandemic is confronting companies with challenges.

In this edition of novus IFRS, we look at significant effects on IFRS accounting and the challenges in preparing annual / consolidated and interim financial statements. The relevance of the topics described below varies widely - depending on the industry and the conditions of the respective company.

If you have any questions regarding these topics, we will be happy to assist you

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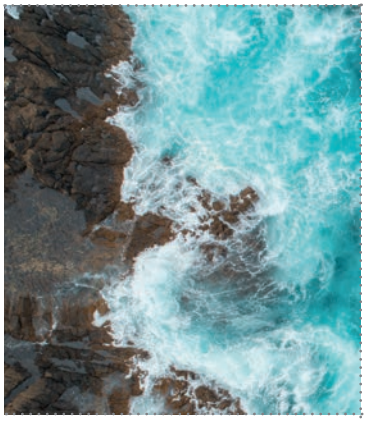

Events after the balance sheet date

The global situation is changing rapidly, especially in light of the corona pandemic. Companies should therefore take into account the provisions of IAS 10 *Events after the Reporting Period* and distinguish between adjusting events and non-adjusting events after the reporting date but before the date on which the financial statements are authorized for publication. Accordingly, they should consider whether recent developments may provide more information about the circumstances at the balance sheet date. Events that provide more information about the spread of coronavirus and the associated costs may also constitute adjusting events. Other events, such as the announcement or adoption of new measures to control and contain the coronavirus or decisions made by the company, are usually not adjusting events. However, if these events are material to the financial statements, they must be disclosed in the notes.

The differentiation of events after the balance sheet date in accordance with IAS 10 is comparable to the differentiation between adjusting events and non-adjusting events under German commercial law. Therefore, no differences between the financial statements prepared in accordance with German commercial law and the IFRS financial statements are generally expected to arise with respect to the assessment of the corona pandemic (cf. IDW's note on the effects of the spread of the corona virus on accounting and auditing (Part 2), Section 3.2.1., of 25 March 2020).

It can be assumed that the occurrence of the coronavirus as a worldwide risk is to be classified as a non-adjusting event, and therefore, the accounting consequences are only to be taken into account in financial statements with a reporting date after 31 December 2019, assuming that the company will continue to be a going concern in the near future.

For balance sheet dates after 31 December 2019, it can generally be assumed that the findings on the consequences of the corona pandemic constitute adjusting events and will thus have to be recognized in the balance sheet. Even though this may depend on the circumstances of the individual case, it is generally assumed that the pandemic must be recognized in the financial statements at 31 March 2020 (see IDW Note on the effects of the spread of the corona virus on accounting and auditing (Part 2), Section 3.2.1. of 25 March 2020).

Impairment of non-financial assets

Impairment in accordance with IAS 36 *Impairment of assets*

Almost every company is affected by the corona pandemic, although the effects can vary depending on the industry and the company. Effects on individual line items and areas of accounting are already foreseeable today. Many companies will have to consider a possible impairment of non-financial assets.

In accordance with IAS 36 *Impairment of Assets*, companies must assess at each reporting date whether there is any indication that an asset (in particular intangible assets (IAS 38), goodwill (IFRS 3), property, plant and equipment (IAS 16) and investment property carried at cost (IAS 40)) may be impaired. Irrespective of this, goodwill and intangible assets with indefinite useful lives must be tested for impairment annually.

Events that may indicate impairment include an immediate decline in demand or prices, declining profitability and the temporary cessation of business operations, as well as the effects of reduced economic activity (e.g. short-time work) and a decline in market capitalization (below the carrying amount of net assets).

In particular, the industry and the respective business model must be taken into account in the assessment.

It can be assumed that there will usually be indications of impairment for interim financial statements at 31 March 2020.

Companies should therefore pay special attention to the following points:

- Cash flow estimates are based on the current approved financial plans. These are generally to be used for a maximum forecast period of five years. The assumptions and cash flow forecasts contained therein, which are used for impairment testing, should be updated to reflect the potential impact of the corona pandemic, taking into account the prevailing uncertainty about the extent and duration of the impact. The largest impact of the corona pandemic should occur in the first year of the detailed planning period. Greater emphasis should be placed on external evidence, even though obtaining external evidence for reasonable and supportable assumptions (see IAS 36.33(a)) is a particular challenge, as economic forecasts are currently rather cautious and vary widely.

- Companies should also ensure that appropriate risks are reflected either in the expected cash flows via the probability-weighted scenarios (expected cash flow approach) or in the capitalization rate (traditional approach).

- In order to capture the increased risk and uncertainties in cash flow estimation, several probability-weighted scenarios (the "expected cash flow approach") could be used instead of a single estimate. The potential impact of measures to contain the spread of the virus could be included as additional scenarios in an expected cash flow approach. A range of potential cash flows would be conceivable, taking into account different scenarios.

- However, even with the traditional approach, the current uncertainties make it appropriate to plan several scenarios and use the cash flows for the most probable scenario. The increased risk should then be reflected in the weighted average cost of capital (WACC). If the WACC cannot be derived appropriately, a risk premium should be applied.

- When extrapolating trend developments from the detailed planning period, which is usually done by extrapolating the cash flows from the last year of the detailed planning period (perpetual annuity), the growth rate used for subsequent years must be adjusted if necessary to take account of the current economic conditions. It should be noted that trend development or an expected upturn for the years 2021 and 2022 is subject to a high degree of uncertainty. Companies should therefore monitor the development of the economic environment and update their planning on an ongoing basis (shorter planning cycle).

The determination of the recoverable amount poses considerable challenges for companies against the background of the currently prevailing uncertainty about the extent and duration of the effects of the corona pandemic. IAS 36 provides for comprehensive disclosure requirements: the more uncertain the current environment, the more important it is for companies to disclose in detail the assumptions made, the evidence on which they are based and the effects of a change in key assumptions (sensitivity analysis) and input factors used. Management assumptions and estimates should therefore be explained in detail in the notes, as future financial statements will focus on them in particular and thus on a transparent and comprehensible presentation (IAS 36.132, .134, IAS 1.125 ff.).

Property, plant and equipment

In addition to any impairment of property, plant and equipment in accordance with IAS 36, other issues are also relevant. The corona pandemic and the measures introduced to control the virus may result in property, plant and equipment not being able to be used or not being fully used for a certain period of time or in investment projects being suspended (if only temporarily). According to IAS 16 *Property, Plant and Equipment*, depreciation must continue to be recognized in profit or loss even if an asset is (temporarily) no longer used. If the development of an asset is interrupted for a longer period of time, IAS 23 *Borrowing Costs* requires the capitalization of interest in the cost of production to be suspended.

Associated companies and joint ventures valued at equity

Investments in joint ventures and associates accounted for using the equity method are tested for impairment in accordance with IAS 28 *Investments in Associates and Joint Ventures*. Management should therefore consider whether the effects of the corona pandemic and the measures taken to control the virus are objective evidence that the net investment in the associate or joint venture is impaired. The above comments on impairment in accordance with IAS 36 *Impairment of Assets* apply here as well.

Note: Investments in joint ventures and associates that are within the scope of IFRS 9 *Financial Instruments* are subject to the impairment provisions of IFRS 9.

Inventories

Impairment losses may also arise for inventories due to the corona pandemic and its effects. These may have to be written down to net realizable value (IAS 2.9). Reasons for this may be:

- lower inventory turnover (especially for perishable or seasonal products)
- falling raw material prices (which have an impact on the selling price)
- rising raw material prices (which cannot be passed on to the market due to declining demand) or
- obsolescence of inventory due to lower sales.

In the current difficult economic environment, calculating net realizable value may be more challenging and may require more detailed methods or assumptions.

In addition, in accordance with IAS 2 *Inventories*, inventories are to be measured at production-related direct and indirect materials and labor costs. Indirect labor costs are to be taken into account when measuring inventories on the basis of the customary full utilization of production capacity. Low utilization of production capacity, e.g. due to plant closures or unusually low demand, can lead to the capitalization of excessive overheads ("idle capacity costs"). Manufacturing companies may have to adjust the calculation of overheads or, more generally, of production costs. The obligation to write down to net realizable value applies equally to raw materials and supplies, work in progress and finished goods.

In addition, the notes to the financial statements must also contain information on the measurement of inventories, if necessary adjusted, and on write-downs in accordance with IAS 2.

Impairment of financial assets and losses from hedging transactions

Impairments

If a company has financial instruments that fall within the scope of IFRS 9 *Financial Instruments*, the effects of the corona pandemic on the expected credit loss (ECL) model should be taken into account and any impairment losses for expected credit losses should be recognized.

The impact of the corona pandemic on ECL will be particularly challenging for banks. However, banks are not the only ones affected.

The effects could also be significant for industrial companies, because the ECL model is relevant for various investments in interest-bearing financial assets (e.g. bonds and notes), trade receivables, leasing receivables, contract assets as defined by IFRS 15, as well as loan commitments and financial guarantees.

Due to intra-group transactions, single-entity financial statements are often more affected than consolidated financial statements.

Companies should consider the effects of the corona pandemic, especially with regard to the following two aspects:

- Measurement of the ECL in the amount of the expected 12-month credit loss (Stage 1) or – if the credit risk has increased significantly since initial recognition – in the amount of the expected credit loss over the (remaining) lifetime (Stage 2) or, if there is objective evidence of impairment, in the amount of the expected credit loss over the (remaining) lifetime when interest recognition is adjusted in subsequent periods (calculation of interest income based on net carrying amount, Stage 3). The following points must be considered when assessing whether the credit risk has increased significantly:
  - The current situation should not lead to an undifferentiated, automatic transfer of financial instruments from Stage 1 to Stage 2 or even Stage 3, as this could significantly overstate the actual economic risks.
  - Appropriate and reliable forward-looking information, the effects on the credit default risk derived from past experience, must be taken into account.
  - The estimation uncertainties and discretionary powers are to be exercised appropriately, especially against the background of the currently prevailing exceptional situation.

(see Technical Note of the IDW Bankenfachausschuss (Banking Comittee) (BFA) on the effects of the corona pandemic on impairments of financial instruments according to IFRS 9 in the quarterly financial statements of banks as of 31 March 2020, Section 3, of 27 March 2020).

If the simplified approach is applied (e.g. for trade receivables), the ECL is always measured on the basis of the expected credit loss over the (remaining) lifetime (Stage 2).

- Estimate of the ECL itself. This includes:
  - the credit risk (default risk), which may increase, for example, if borrowers (companies as well as private individuals) are affected by the effects of the corona pandemic,
  - the exposure at default if borrowers affected by the effects of the corona pandemic use existing but previously unused credit facilities, are late on their interest and principal payments (deferrals) or stop making such payments, which in each case leads to greater exposure,
  - the loss given default (LGD), which may increase due to the loss in value of the collateral (as a result of an observed general decline in asset prices).

IFRS 9 requires forward-looking information (including macroeconomic information) to be taken into account both in assessing significant increases in credit risk and in measuring ECL. Government stabilization measures must be taken into account in this context in order to mitigate risk appropriately. It cannot be assumed that a failure to consider forward-looking information will be considered appropriate in view of the existing uncertainties.

Companies should therefore update their credit risk models for determining ECL to include the following points:

- Historical data alone is not sufficient; forward-looking information must be supplemented:
  - Forward-looking information could include additional downward scenarios related to the spread of the coronavirus. For example, existing macroeconomic scenarios could be adapted (e.g. taking into account serious disadvantages and/or adjusting their weighting – stronger weighting of long-term stable scenarios so that short-term developments are not overweighted) or supplemented by one or more scenarios.
  - Risk matrices based on historical information, which were used in the simplified procedure to determine the ECL for items such as trade receivables, must be reconsidered.

According to IFRS 9, forward-looking information must be taken into account both when assessing the significant credit risk increase and when measuring ECL. Forward-looking information could include additional downside scenarios related to the spread of the coronavirus

- All available information from the market, such as updated ratings, forecasts, etc. must be taken into account. It must be examined to what extent existing ratings already reflect the effects of the corona pandemic.
- If the effects are not taken into account in the ECL model (and this is likely to be true in most cases), then post model adjustments (possibly also for the transfer of levels) must be taken into account. These are necessary, for example, if higher defaults are expected for certain industries or customer segments than those resulting from the credit risk model (if current developments are not adequately taken into account in the model). In addition, government measures should be taken into account when determining the post model adjustment. A further complicating factor is that the long-term consequences of the pandemic cannot be reliably estimated, so expert opinions vary widely.

It should be noted that a holistic assessment should be carried out, focusing on a change in credit default risk over the entire expected remaining life of the financial instrument.

In addition, governments are calling on banks to support borrowers affected by the corona pandemic. This can take the form of things such as interest and repayment deferrals on existing loans. Banks that provide such support should take this into account when assessing the significant increase in credit risk or when measuring ECL.

Companies should disclose the impact of the corona pandemic on the impairment of financial assets and the other financial instruments in accordance with IFRS 7 *Financial Instruments*: Disclosures (e.g. inclusion of forward-looking information and material changes to assumptions made in determining the ECL).

Fair value measurement

Fair value measurement in accordance with IFRS 13 *Measuring Fair Value* is relevant for various balance sheet items (including financial instruments, investment property measured at fair value, in connection with the impairment test under IAS 36 (where the fair value less costs of disposal approach is applied), measurements in accordance with IFRS 5 and various notes). IFRS 13 provides for a three-level fair value hierarchy. The classification is based on the level of the lowest significant input factor (IFRS 13.73).

The increased volatility and falling prices in the capital markets as a result of the corona pandemic have either a direct impact on the measurement of fair value (Level 1, e.g. for equities or debt instruments traded in an active market) or an indirect impact, if a measurement is based on inputs derived from volatile markets (e.g. for interest rate and currency derivatives) (Level 2). For example, counterparty credit risk and the credit spread used to determine fair value may increase, but the impact of government measures to stimulate the economy may reduce risk-free interest rates. Particular attention should be paid to Level 3 input parameters, which may be significantly affected by the corona pandemic. Companies must ensure that the unobservable input parameters do not contradict the assumptions of market participants considering the effects of the corona pandemic. The number of Level 3 instruments (e.g. property measured at fair value) could increase as a result of the corona pandemic.

Particular attention should be paid to Level 3 input parameters, which may be significantly affected by the corona pandemic.

Companies should consider the impact and disclosures required by IFRS 13 when making changes to fair value measurements. For example, the valuation techniques and the input parameters used must be disclosed.

Hedge accounting

In hedge accounting, affected companies will have to critically examine whether the conditions for hedge accounting are still met if the underlying transaction and the hedging transaction change significantly. In the case of cash flow hedges in particular, it must be assessed whether or not the occurrence of transactions can still be expected with a high degree of probability, given the corona pandemic. The following transactions, which are part of a cash flow hedge, could be affected by the effects of the corona pandemic:

- Sales or purchase volumes that are lower than originally forecast
- planned bonds that are delayed or cancelled, so that interest payments fall below the level originally forecast, and
- delayed or cancelled mergers and acquisitions.

If the occurrence of a forecast transaction is no longer highly probable, the hedging relationship must be terminated prospectively and the amount must be reclassified from the cash flow hedge reserve to the income statement. It is generally not possible to (alternatively) refer to a correspondingly higher transaction volume in a later period unless this was part of the originally planned and sufficiently identified expected transaction. This does not apply in individual cases if the originally planned transaction does not take place as planned due to an unforeseeable event, but is carried out sooner or later within a reasonable period of time and with sufficient certainty (see IDW RS HFA 48, paragraph 344 ff.).

Leases

The effects of the corona pandemic could lead tenants or lessees to renegotiate the terms of their lease. In addition, the lessor may grant the lessee a concession. In such a case, the lessee should consider the requirements of IFRS 16 *Leases* and consider whether this will lead to a change in the lease and whether the effect of the change in the contract or concession should be spread over the remaining term of the lease (with a different discount rate). This is the case if the scope of use of the asset or the amount of the lease payments is adjusted over the remaining term of the lease, i.e. not already provided for in the original lease agreement. Legally required or originally contractually provided for rent waivers (e.g. force majeure clauses) are therefore not to be taken into account as contract adjustments, but as negative variable lease payments. Remissions (or partial remissions) of lease liabilities that are not contract modifications must therefore be recognized in income in accordance with the derecognition rules in IFRS 9.

It can be assumed that the rent concessions currently resolved in Germany, which are still due, do not represent a modification of the lease.

In the case of rent liabilities resulting from the effects of the corona pandemic, the requirements of IFRS 16 must be observed in the accounting books. On 1 April 2020, regulations on protection against termination came into force which stipulate that tenants cannot be terminated for the period from 1 April 2020 to 30 June 2020 because of default in paying their rent due to the corona pandemic. The rent remains due for this period. As a result, tenants may be in arrears and default interest may become due if the payment is not made on time. It can be assumed that such rent concessions that remain due do not constitute a modification of the lease. The lease liabilities are to be repaid over the remaining contractual term.

If rent payments are waived in whole or in part, each agreement must be examined to determine whether it constitutes a modification of the lease and to consider the corresponding impact on the balance sheet.

On 24 April 2020, the IASB published a draft amendment to IFRS 16, which is intended to enable lessees to waive an examination of whether a contract modification exists for rent concessions due to the corona pandemic. As a result, changes in lease payments by the lessor and lessee would have to be recognized in profit or loss as negative variable lease payments in accordance with IFRS 16.38. In the case of an operating lease, the lessor recognizes the effect of the rent concession by recognizing lower income from the lease.

Entities should also assess whether rights to use assets (lessees) and property, plant and equipment subject to operating leases (lessors) are impaired in accordance with IAS 36 *Impairment of Assets*. Rent concessions resulting from the effects of the corona pandemic are circumstances that probably indicate that assets may be impaired. Concrete indications of impairment of the underlying right of use may include:

- loss of income during the period covered by the rent concession
- longer-term effects of the corona pandemic on expected current lease payments (impairment of the economic performance of the lessee).

Rent concessions resulting from the effects of the corona pandemic are circumstances that probably indicate that assets may be impaired.

Entities should also include information in the notes to the financial statements that is relevant to understanding the impact of changes in leases due to the corona pandemic on the entity's financial position and financial performance (see IAS 1.31).

Recognition and adjustment of provisions, changes in the presentation of liabilities and tax effects

Provisions for onerous contracts

Disruptions in the provision of services as a result of the corona pandemic (e.g. higher production costs, time delays) and the measures introduced to control the virus may mean that provisions for onerous contracts must be recognized as liabilities in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (cf. IAS 37.66-69). This may be relevant in the following cases, among others:

- where a customer claims penalties (liquidated damages) for delayed or undelivered products,
- where production costs increase, e.g. due to the replacement of employees who are infected, quarantined or otherwise excluded from traveling or due to procurement problems, if alternative raw materials and/or products can only be purchased at a higher price,
- for rental or leasing contracts (e.g. of real estate).

However, companies should consider whether the underlying terms of the contract allow for termination in exceptional circumstances without a penalty (material adverse change (MAC) or force majeure clauses). The corona pandemic could be considered "force majeure". In such cases, companies can avoid the obligation to accept or deliver and the obligation to set up a provision for onerous contracts is not applicable.

Note: For assets (e.g. intangible assets, property, plant and equipment, inventories, contractual assets), a provision for onerous contracts is not recognized for the excess amount until the asset is fully impaired.

Employee benefits and share-based payment

Companies should consider whether any of the assumptions made for the recognition of employee benefits and share-based payment should be updated in light of the corona pandemic. Changes may occur in the following areas, among others:

- Change in the probability of fulfilling the vesting conditions for bonuses or share-based payments, for example, due to the discontinuance of operations or reduced capacity,
- Change in the expected return on plan assets and yields on senior bonds in the measurement of pension obligations,
- Change in the risk-free interest rate in a specific currency in the valuation of long-term provisions.

Companies should consider the effects of the amendments in accordance with IFRS 2 *Share-based Payment*. For example, if it becomes unlikely that a performance condition will be met, previously recognized compensation expense should be reversed.

In addition, changes to share-based payments and information on the determination of the fair value of the goods or services received or the equity instruments granted must be explained in the notes (cf. IFRS 2.44 ff.).

The corona pandemic and the associated economic uncertainty may also affect the measurement of defined benefit obligations and plan assets, which must be determined at the end of each reporting period. The above considerations regarding the measurement of financial and non-financial assets at fair value are also relevant to the measurement of plan assets in accordance with IAS 19 *Employee Benefits*. For example, there may not currently be an active market for a significant portion of assets (e.g., hedge funds, structured products and real estate assets). The appropriate determination of fair value for such assets is important for the valuation of defined benefit plans.

IAS 19 requires full disclosure of the assumptions used to estimate employee benefit liabilities and the sensitivities and changes in these assumptions.

Covenant breaches

The financial impact of the corona pandemic and the measures taken to control the virus may also lead to some companies breaching covenants in credit agreements or triggering unfavorable contractual clauses (e.g. additional collateralization of loans, change in loan terms and conditions). This could lead to a change in the repayment terms for loans and, in some cases, to the loans having to be repaid in full on demand. Companies should therefore check whether:

- the classification of loans and other financial liabilities as current or non-current is still appropriate (IAS 1)
- cross default clauses and changes in credit terms will affect the company and
- the company will continue to a going concern in the near future.

Income taxes

The corona pandemic can directly and indirectly influence future profits of companies, with effects on customers, suppliers and service providers. Companies should therefore check whether:

- the projected profits and the recoverability of deferred tax assets have to be reassessed in accordance with IAS 12 *Income Taxes*, taking into account the prevailing uncertainty about the extent and duration of the effects of the corona pandemic
- impairments of assets reduce the amount of deferred tax liabilities and/or lead to additional deductible differences
- assumptions and forecasts shall not contradict the assumptions and forecasts mady by management in the context of the impairment test in accordance with IAS 36
- any changes in tax rates must be taken into account
- the impact of the corona pandemic on the plans for distribution of profits of subsidiaries and therefore the recognition of a deferred tax liability related to undistributed profits needs to be reviewed
- all significant judgments and estimates relevant to the assessment of the recoverability of deferred tax assets are disclosed in accordance with IAS 1 *Presentation of Financial Statements*.

IMPRINT

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