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Challenges for Tomorrow's Management

Accounting implications of the COVID-19 outbreak

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Gladie Lui
ESCP Business School

Paul Pronobis
ESCP Business School

Francesco Venuti
ESCP Business School

ESCP Research Institute of Management (ERIM)

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Gladie Lui
ESCP Business School

Paul Pronobis
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Francesco Venuti
ESCP Business School

Abstract

This impact paper provides an overview of the major challenges CFOs face in the light of the current COVID-19 crisis when preparing their financial statements. In particular, CFOs need to consider the magnitude of disruption caused by the outbreak to their business operations and adequately disclose the information about those assets and liabilities that are subject to significant estimation uncertainty. Furthermore, the question arises whether the outbreak represents an event before or after the end of the recent reporting period (FY 2019) which needs to be discussed in the (current) financial statements of 2019. Also, CFOs need to revisit the accounting for fair value estimates, expected credit losses (ECLs), impairments, and other assets. Finally, CFOs should carefully assess whether these events or conditions may compromise the company's ability to continue as a going concern.

Keywords: COVID-19 disclosures, Estimation uncertainty, CFO reporting

Accounting Implications of the COVID-19 Outbreak

The outbreak of COVID-19 and the consequent measures taken by many governments all over the world happened exactly during the period of the year when many companies are preparing their annual financial reports. Moreover, the uncertainty about the future evolution of the situation raises a lot of questions and challenges with respect to accounting measurement and valuation. What is the impact of the outbreak on different accounting periods? How is it going to affect the company's going concern? Is it possible for CFOs in the current situation to provide in their financial statements a “true and fair” representation regarding estimations, judgments, and assumptions? This study examines and discusses some of the most significant financial statements’ implications due to the COVID-19 outbreak and provides actionable items on how to deal with the evolving situation.

The current coronavirus crisis has led many countries to disrupt firms’ business activities. Disruptions are more immediate and pronounced in certain industries such as tourism, hospitality, transportation, retail, and entertainment, while there are also anticipated knock-on effects on other sectors such as manufacturing and the financial sector. As the outbreak continues to progress and evolve, it is challenging at this juncture, to predict the full extent and duration of its business and economic impact. In the current situation, considering the publication of the first studies and forecasts (see OECD, IMF, EU), probably no economic activity in the world could have avoided considering itself affected by this situation. Consequently, these circumstances may present a great challenge also for *CFOs* of companies in their pursuit to address the financial effects of the novel coronavirus outbreak when communicating with their stakeholders. These challenges are already present when preparing financial statements for the year ended 31 December 2019 (the reporting date), but even more as the approval of the interim 2020 approaches. Local regulators in almost all the countries overwhelmingly affected by the COVID-19 have already adopted (or are on the way to adopting) specific rules to face this exceptional situation, affecting, among many other things, also the financial reporting and disclosures practices of companies (for example in terms of deadlines for publication and approval of the annual reports). Also, international standard setters (i.e. IASB, FASB) have reacted to this situation by amending the effective dates of certain accounting principles (e.g. amendment of IFRS 16 *Leases*).

One of the biggest concerns comes from the fact that the financial and economic impact of this pandemic disease is strongly dependent on facts, elements, and variables, that are largely still extremely difficult to predict, even in general terms. For example, it is unquestionable that the future evolution of this situation largely relies on two fundamental elements: the results coming from scientific/medical research (i.e. vaccine and new effective medical treatments) and the reaction of the population (in terms of compliance) to the norms that regulate both the lockdown and the slow reopening (“back to normality”) that will follow in many countries.

Consequently, from an accounting, reporting, and audit perspective, the challenge becomes how each entity can “translate” the effect of those macro conditions into reliable estimates of its own accounting metrics. Additionally, from a slightly different perspective, how can we ensure that the decisions and estimations of different companies about this uncertain and unprecedented situation would be compliant to the accounting principle and, moreover, will be comparable, in order to protect the interest of investors, stakeholders, and markets?

Analysis

The analysis that follows will examine the major accounting challenges that the COVID-19 outbreak is raising for both current and future accounting period(s), with the impact on companies' financial statements. CFOs, accountants, and auditors need to "do their best" to provide "fair" and reasonable estimations, judgments, and assumptions in order to come up with reliable results, reports, and disclosure, accompanied by clear supportive documentation that provides evidence to their assumptions and estimates. Table 1 below summarizes the key issues together with possible actions that a CFO can undertake to cope with each issue. A detailed analysis follows, which is developed with IFRS financial statements in mind. The main conclusions, however, are consistent with other accounting regulations, such as U.S. GAAP.

MAJOR ACCOUNTING ISSUES TRIGGERED BY COVID-19 CRISIS	CFO ACTION ITEMS
*Does the COVID-19 outbreak represent **an event before or after the end of the recent reporting period** (FY 2019) which needs to be discussed in the financial statements of 2019?*	The COVID-19 outbreak can be **generally considered a non-adjusting event**. However, due to materiality, the nature and the implications of the outbreak, the implications should be discussed in the management report.
*Does the COVID-19 outbreak have implications for the **going-concern assumption** of the company?*	CFOs need to revise their budgets, plans, forecasts, and sensitivities, evaluating carefully the implications of the outbreak in terms of liquidity, solvency, and profitability of the company. In case of uncertainties, it has to **be reported that the going-concern assumption might be subject to material uncertainties**.
*Does the COVID-19 outbreak affect the **fair value measurements** of assets and liabilities?*	Being a market-based measurement, fair values will be affected. CFOs may be challenged in evaluating carefully the conditions for "**active markets**". Assumptions and judgements applied during the valuation process should be documented. Moreover, potential **breach of loan covenants** should be monitored carefully, in order to prevent potential problems in the company solvency.
*Does the COVID-19 outbreak impact the **expected credit loss (ECL)** assessment under **IFRS9**?*	CFOs have to re-estimate the probability of default of many borrowers, in order to evaluate properly all their receivables, accounting for adequate provisions for bad debts. While the 2019 ECL will not incorporate the effect of all subsequent measures, the forward-looking approach of IFRS 9 requires CFOs to anticipate

	the future expected loss to the current period, with the risk of amplifying the losses.
*Does the COVID-19 outbreak represent a triggering event for non-financial assets **impairment testing**?*	The consequences of the outbreak of COVID-19 are clearly external indicators or **events that might require CFOs to perform impairment tests for their non-financial assets.** Moreover, the outbreak of COVID-19 will impact all the elements involved in the procedure of the impairment test: the recoverable amount, the estimated future cash flows, the discount rate and even the book value of the non-current non-financial assets.
*Does the COVID-19 outbreak require **other financial statement disclosure**?*	CFOs have to report in the financial statements all the information that **enables users of the reports to understand the impact of the outbreak on their financial position and performance**, such as additional information about risk exposures, provisions for onerous contracts, plans to restructure, changes in the company's objectives, policies and risk management processes or methods, even if this occurred after the reporting date.
*Does the COVID-19 outbreak specifically affect **other sectors or industries with particular regulation**?*	Specific industries, such as **insurance companies**, are directly affected by the COVID outbreak, especially in a moment of transition through a new complex accounting standard (IFRS 17, further deferral of effective date to 1 January, 2023).
*Does the COVID-19 outbreak affect **Lease Contracts Accounting under IFRS 16**?*	In this time of uncertainty, companies may need to change their lease payment schedules, resulting in lease modification accounting or variable lease payments accounting. However, the International Accounting Standards Board plans to issue amendments by the end of May 2020 regarding a proposal on accounting for lease modifications.

Table 1: Major accounting issues due to COVID-19 and actionable items

• <u>Events before and after the end of the reporting period</u>*: determining whether an event is an adjusting or a non-adjusting event is crucial and, in some situations, might not even be so obvious or simple.*

Although the outbreak of the COVID-19 started originally at the end of 2019 (China made it "official" on exactly December 31, most of the effects that have to be reported on annual financial statements seem to be more a consequence of events that occurred later during the first months of 2020. Nevertheless, a decision on whether an event is an adjusting or a non-adjusting event becomes crucial and, in some situations, might not even be so obvious or simple, and not only depending on a company's reporting date.

As adjusting events, according to IAS 10 "Events After the Reporting Period", are those that provide evidence of the conditions that existed at the reporting date (i.e. December 31st), the crucial question that accountants and auditors have to ask themselves in making their reporting evaluations is which event is relevant and at which date? (For example, in evaluating a certain item, is it just the outbreak of the virus that has to be considered or the restrictions and the measures adopted by Governments as a reaction?). In order to answer this question, all the information available about the timeline, the nature and the cause-effect of both the outbreak of the virus and the consequent measures adopted should be carefully evaluated.

Reasonably, for reporting periods ending at 31 December 2019, the financial reporting effects of the COVID-19 outbreak can be generally considered as non-adjusting events (with the exception of going concern) as the outbreak itself did not directly have a significant impact on markets, prices, and business until after the end of January 2020, when the World Health Organization announced a global health emergency (even if the Wuhan Municipal Health Committee issued its first urgent notice about the virus on 30 December 2019). If non-adjusting events are material (as the COVID-19 reasonably is), companies have to disclose in the notes to the financial statements, the nature and the implications of the Coronavirus and of the other related events (i.e. Government restrictions and other reactions) and, possibly, estimate their financial effects. As such, the nature and the implications of the outbreak should be discussed in the management report.

For reporting dates after 31 December 2019, the outbreak and the consequent measures could be both an adjusting or a non-adjusting event. Accountants and auditors will then consider all the additional available information available for their assumptions, evaluations, and assessments. Accordingly, an adjusting event for subsequent reporting dates should be expected. For future accounting periods (and, obviously, for interim reports), COVID-19 will become a current-period event that will require ongoing evaluations.

• <u>Going concern</u>*: the entity prepares the financial statements under going concern assumption and BEFORE the issuance of financial statements.*

The distinction between adjusting and non-adjusting events previously examined does NOT apply to the going concern assumption. All companies (not only the ones directly affected by this situation) have to assess whether these events or conditions may compromise the company's ability to continue as a going concern or, in the worst-case scenario, whether the assumption of the going concern could still be considered valid for the preparation of the financial statements. Going concern is considered to be one of the basic accounting principles for general purpose financial statements.

Considering all the potential impacts (both direct and indirect) of the outbreak as well as the measures taken by governments and other institutions, the management has to revise their budgets, plans, forecasts, and sensitivities carefully evaluating the implications in terms of liquidity, solvency, and profitability for their companies. Given the high level of uncertainties about the future evolution of the situation and the consequent impacts, probably reviewing the plans through a multiple (different) scenario approach would be the best option. Additionally, significant attention should be devoted to the managerial decisions, the actions and the plans that the company intends to realize in order to face the evolution of the situation and to mitigate the effects that potentially raise doubts on the company's ability to continue as a going concern.

• Fair value measurement: *Assets and liabilities measured at fair value are affected, which may lead to violating debt covenants.*

Fair value is one of the key relevant measurement criteria for many items in IFRS financial statements. Fair value is a market-based measurement (and not an entity-specific measurement) that reflects the market conditions as of the measurement date. IFRS 13 defines fair value as 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.

The current situation may create some difficulties in relation to the concept of "active market", especially when significant decreases in volume or activity (frequency) of transactions affect the ability of the market price to match the definition of fair value, although this situation does not automatically imply that the market is not active anymore.

Considering that the "fair value hierarchy" requires a preference for the use of "observable inputs" (Level 1 and 2) rather than "unobservable" ones (Level 3), significant judgment from accountants and auditors may be needed for assessing the relevance of observable market data and whether they reflect orderly transactions in active markets.

When observable inputs and market data are not available, fair value measurement would be based on "unobservable inputs" (Level 3) and become particularly challenging, given the high level of uncertainty about the evolution of the situation and considering that the circumstances may change rapidly and quite unexpectedly. Besides, it certainly requires additional disclosures.

Developing assumptions (inputs) that market participants would use when pricing an asset or a liability under current market conditions, including assumptions about risk, using the best information available may not be easy.

In this contest, managers should seriously consider resorting to external valuation specialists and push even further the level of transparency about the techniques, key assumptions, sensitivities, and sources of the estimations.

Besides all the problems related to the fair value measurements, a significant change in the value of assets and/or liabilities, market downturns and contraction due to the lockdown and other restrictive regulation (i.e. social distancing, quota, etc…), instability in trading conditions and shortages of cash flows may lead companies to violate debt covenants, incurring penalty payments or increases in interest rates. This breach in the debt covenant may affect the timing of repayment of loans and/or other liabilities and, consequently, the classification in the financial statements of the related liabilities at the reporting date (i.e. current vs. non-current). The key elements here would be the date of the breach of loan covenants (before or after the reporting date), whether it is material or not, and the impact on the company solvency (and, consequently, on the going concern assumption, as previously examined).

• Expected credit loss assessment: *Accounts receivables, loans, leases etc. may have decreased in value. In addition, IFRS 9 has a "procyclical effect" which makes banks particularly susceptible to the highs and lows (saw-tooth) of economic cycles.*

One highly probable (and quite obvious) consequence of this crisis will be a significant increase in the probability of default (PD) of many borrowers. For example, many companies should quite reasonably expect a deterioration in the credit quality (i.e. an increase in the PD) for one or more entities, along their supply chain. The switch from an "occurred approach" (IAS 39) to a "forward-looking approach" (IFRS 9) has an implication for all companies to anticipate and account for what they expect the loss to be, evaluating and estimating how the current and the future economic conditions are supposed to impact on the expected credit loss (ECL).

This approach has significant consequences on companies in almost all sectors and industries. First of all, it will clearly have a huge impact on banks, lending businesses and financial institutions, as they probably expect a deterioration in the quality of their credits (loan portfolios). Secondly, these effects will probably also affect all other investments (made from any type of company) in any interest-bearing financial assets (e.g. bonds, lease, debentures). Finally, it will probably have quite a huge impact on the trade receivables. In this context, companies with a shorter cash cycle, low amounts of trade receivables, will be less impacted.

The disclosure of the estimated financial effect should be quantitative information about how the outbreak is expected to affect the ECL allowance based on the information available after the reporting date but before the financial statements are authorized for issue. From a practical perspective, this would often mean running the ECL exercise again with, or adjusting it for, the latest available information on a date close to when the financial statements are authorized for issue.

• Non-current assets impairment: *Future cash flows are much harder to predict when conducting impairment tests.*

According to IAS 36 non-current non-financial assets with indefinite life (such as goodwill) have to be tested for impairment annually. Additionally, other non-financial assets have to be tested whenever there is an indicator that those assets might be impaired. The consequences of the outbreak of COVID-19 are clearly events that might indicate impairment. Consequently, many businesses may have to consider additional testing for impairment of their non-financial assets.

Besides, the outbreak of COVID-19 will impact almost all the elements involved in the procedure of the impairment test: the recoverable amount, the future cash flows, the discount rate and even the book value of the non-current non-financial assets.

First of all, in the impairment test, the recoverable amount (as the higher of the value-in-use and the fair value net of the costs of disposal) has to be determined and compared with the book value of the asset. As the value-in-use is mostly determined from the net present value of the expected future cash flows from the asset or cash generating unit (CGU), it is reasonable to assume that both the forecasted future cash flows and the discount rate will be deeply affected by this situation.

As for the future cash flow estimations, changes in economic, market and specific sector conditions must be considered and, given the high level of uncertainty, a multiple scenario and probability-weighted approach, combined with data and simulations from official external sources (such as central banks and reliable international studies from respected organizations) may be suggested.

Additionally, both the two basic components of the discount rate (the risk-free rate and the entity-specific risk premiums) will be affected. Even if the risk-free rate for some countries (measured as the yield on long-term government bonds) has decreased in the last months (due to the increase in prices in some government bonds), this decrease is fully offset by the increase in risk premiums related to the uncertainties and the rise of risks for the specific company. In order to not overestimate the phenomenon by double-counting some elements, it should be checked that the discount rate does not include the impact of any factor that has already been considered in estimating the future cash flows.

Last but not least, due to some changes in market conditions, in the company strategy or in operational activities, the useful life and the residual value of some non-current assets might be changed and, consequently, its depreciation schedule (or even its depreciation method), affecting the book value of the asset.

• Other financial statement disclosure requirements: *Entities should disclose information that enables users of the financial statements to understand the impact of the outbreak on their financial position and performance up to when the statements are authorized for issue.*

IFRS 7 requires an entity to disclose information about the nature and extent of risks arising from financial instruments to which it is exposed at the reporting date (‘risk disclosures’). Entities should review whether their risk disclosures provide sufficient information that enables users of financial statements to evaluate the risks to which the entity was exposed as of 31 December 2019. In light of the developments of the novel coronavirus outbreak, additional information about risk exposures may have to be given, or in a different form than before. For example, concentrations of risk could be extremely relevant as those developments affect different geographical areas, economic sectors or customer segments differently. Also, in light of those developments, the exposure to liquidity risk and how it is managed might be more important and relevant to users of the financial statements now than it was for past reporting periods.

In addition, if the entities have changed their objectives, policies and processes for managing risk, or the methods to measure it, that should be disclosed. Even if this occurred after the reporting date, that information might be relevant to users of the financial statements for the same reasons that underpin the disclosure regarding non-adjusting events in IAS 10.

• Other accounting estimates: *A specific focus could be on the impact on the insurance sector, which is undergoing a “transition phase” through the adoption of the new IFRS 17 (combined with IFRS 9).*

Insurance companies will be deeply affected by the COVID-19 both on their operating activities and on investing activities, which are rigorously combined. Moreover, around 80% of the liabilities of an insurance company are represented by technical provisions and reserves, which come from complex future actuarial estimates that will be deeply impacted by this situation. For these reasons, huge pressure for further postponement or even changes to the new accounting regulation specific for this sector is being raised. Most insurance companies had already adopted (long before the COVID-19 outbreak) the “deferral approach”, that allowed them to postpone the adoption of IFRS9 (especially for the evaluation of their assets) up to the adoption of the “new” IFRS17 (especially for the evaluation of the insurer liabilities, technical provisions and reserves). Now, the COVID-19 outbreak is going to put more pressure on deferring the “combined” adoption of IFRS9 and IFRS17 for those companies.

Conclusion

CFOs need to consider the magnitude of the disruptions caused by the outbreak to their businesses and adequately disclose the information on those assets and liabilities that are subject to significant estimation uncertainty, in order to provide stakeholders with a better understanding of the financial implications. The financial implications of the outbreak will put more pressure on CFOs, asking them for evaluations, estimations, and decisions that cannot be “delegated” as well as applying rules to what is called a “VUCA” situation. They will get out of it not simply by mechanically “applying” accounting principles and rules, but by courageously using the most out of their expertise, knowledge and professionalism.

Also, regulators will need to take into account the disruptive effects of the current situation and try to carefully balance their role of “protection” of the stakeholders’ interests (in terms of access to transparent, reliable and adequate information) with the uncertainties, concerns, and issues for the companies in providing the requested information to the market.

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