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Reporting the impact of COVID-19 on your business

10 key questions for CFOs…

As the impact of a novel strain of coronavirus (COVID-19) continues to unfold around the world, those individuals responsible for preparing financial statements and approving them for issue need to be cognisant of not only what has happened and is happening at the reporting date and the time the financial statements are approved, but also what is likely to happen next.

IFRS requires that all the material effects of COVID-19 are appropriately recognised, measured and disclosed at the entity's reporting date; be it interim or at year-end.

Here are ten questions entities should be asked to ensure that those financial statements not yet issued are presented fairly. These questions are by no means exhaustive, or indeed listed in any order of priority, because their applicability will depend on facts and circumstances.

1. COVID-19 – the big picture: what should be included in financial statements that have not yet been authorised and approved for issue?

An entity's stakeholders will use financial statements to evaluate the magnitude of potential disruptions to their businesses and if any estimates are included, they will want insight into how these were determined.

The stakeholders will want to understand the impact COVID-19 is having on their business. In many instances, extensive observations will have already been included in the management commentary. For example, an airline commenting on its risks might say this in its management commentary:

An outbreak of disease or similar public health threat, or fear of such an event, that affects travel demand, travel behaviour, or travel restrictions could have a material adverse impact on the Group's business, financial condition and operating results. In addition, outbreaks of disease could result in increased government restrictions and regulation, including quarantines of our personnel or an inability to access facilities or our aircraft, which could adversely affect our operations.

In December 2019, a novel strain of coronavirus (COVID-19) was reported in Wuhan, China. The World Health Organisation (WHO) has since declared COVID-19 to constitute a "Public Health Emergency of International Concern." In January 2020, the government issued a "do not travel" advisory for China. The government also implemented enhanced screenings, quarantine requirements and travel restrictions in connection with the COVID-19 outbreak which impacted passenger numbers. As a result the Group has suspended its flights between Euroland and each of Beijing, Shanghai, Hong Kong… Italy and any affected areas through to May 2020…etc. These routes represented approximately 5% of the Group's 2020 planned capacity and the Group's other trans-Pacific routes represented an additional 10% of its planned capacity. As of the date of this report, the Group is experiencing approximately a 100% decline in near-term demand to China and approximately a 75% decline in near-term demand on the rest of the Group's trans-Pacific routes.

The extent of the impact of COVID-19 on the Group's operational and financial performance will depend on future developments, including the duration and spread of the outbreak and related travel advisories and restrictions and the impact of COVID-19 on overall demand for air travel, all of which are highly uncertain and cannot be predicted. If traffic on the Group's trans-Pacific routes were to remain at these levels for an extended period, and/or routes in other parts of the Group's network begin to see significant declines in demand, our results of operations for full year 2020 would be materially adversely affected.

2. Will the outbreak of COVID-19 result in more disclosures?

The answer to this question is almost certainly yes. In many situations, the outbreak will result in revised obligations or uncertainties that an entity may not have previously recognised or disclosed in its financial statements. The additional disclosures will not only relate to the revenues, expenses, assets and liabilities they have already recognised, but also what might end up recognised in subsequent reporting periods.

Below is some example wording:

The entity has been impacted by COVID-19:
On 11 March 2020, the World Health Organisation (WHO) officially declared COVID-19, the disease caused by novel coronavirus, a pandemic. Management is closely monitoring the evolution of this pandemic, including how it may affect the Group, the economy and the general population. Management has not yet determined the financial impact of these events.

No significant impact of COVID-19:
Management has not been aware of any cases of COVID-19 infection among its people and the outbreak has not had a significant impact to the Group's operations to date. Management currently has an appropriate response plan in place. Management will continue to monitor and assess the ongoing development and respond accordingly.

Country specific:
Euroland is currently in the elimination phase which is strategically planned to slow down the spread of the virus. As a result, at the time of issuing these financial statements, there is a complete lock down of the country [**<Tailor as appropriate to reflect what response the entity/group has taken>** eg: *Our head office and regional offices were closed on 24 March 2020 and our people have implemented alternative working arrangements. The supply for our services remains as expected, however the demand for additional services is uncertain at this time due to not being able to meet face to face with our clients and future clients. In line with advice issued by the government we have closed all our sites from X date to Y date*].

The development of these strategies is in line with global strategies guided by the World Health Organisation (WHO) and European Centre for Prevention and Disease Control (ECDC) and we will continue to implement measures in line with the government direction. While we (the directors) expect a [**<Tailor as appropriate>** *X% increase/decline in operations in Q1/Q2 of 2020 in line with the closure of operations, quarantine measures and travel restrictions*], given the dynamic nature of these circumstances, we have not formally determined the financial impact of these events on our consolidated results of operations, cash flows and financial position. We will continue to monitor closely the global developments of this new virus and respond accordingly.

Material effect but can't quantify:
The Group has closed more than half of its stores which will materially affect the group's international segment/ company's operations in 2020. [**Consider impact on turnover, operating overheads, once off payments e.g. redundancy, potential impairments, cash flow impact…etc**]

The related impact of the Group's operating segments in China and our consolidated results of operations, cash flows and financial position will be material, but cannot be reasonably estimated at this time.

The importance of the Chinese/affected coronavirus area to this business where the impact can be quantified:
For 2019, China/Italy/affected segment represented approximately 15% of sales and 10% of consolidated net profit after tax.

3. There has recently been a significant drop in the value of equities so if you have a 31 December 2019 reporting date, should your financial statements be adjusted for this?

The answer is no. Fair value in accordance with IFRS 13 'Fair Value Measurement' is based on the price to sell an asset at the measurement date. Also, in accordance with IAS 10 'Events after the Reporting Date' a fall in fair value after the reporting date does not provide new evidence about the fair value at the reporting date. However, IAS 10 requires disclosures about 'non-adjusting' events after the reporting date, including abnormally large changes in assets prices (including an estimate of the financial effect unless it cannot be reasonably estimated). NB. This assessment assumes the entity is a going concern.

4. If there is estimation uncertainty, what should be reported in the financial statements?

In 31 March 2020 financial statements, for example, businesses will need to pinpoint where accounting estimates have been made and what assumptions were used to determine the amounts that are reflected in the financial statements. For example, an organisation may have perishable goods that due to market circumstances brought about by COVID-19, will have to be sold for less than it cost to produce them. Having never faced this situation, a range of selling prices exists which means the loss arising from having to write down the value of its inventory will also change. In many instances there will be a range of possible outcomes. IAS 1 'Presentation of Financial Statements' requires disclosure about the assumptions made and the nature and carrying amounts of the assets and liabilities affected. It does not prescribe the exact information you should disclose about these assumptions but gives examples of the types of information:

- the nature of the assumptions
- sensitivity of carrying amounts
- expected resolution/range of reasonably possible outcomes
- changes made to past assumptions.

5. How does information about COVID-19 that becomes available after the reporting date affect the financial statements?

In our view it depends. Entities are required to determine amounts based on their facts and circumstances at the reporting date, not after it. This is particularly important when considering whether assets are impaired or not. When information becomes available after the reporting date, its impact on the financial statements depends on whether it provides additional evidence of conditions that existed at the reporting date. So, the determination of the recoverable amounts of an asset can only consider the information obtained after the reporting date if such conditions existed as at the reporting period end. So if your organisation (with a December year-end) has been severely affected by COVID-19 and has developed plans in 2020 to restructure its operations as a consequence of this, you cannot take this post reporting date decision and its economic consequences into account. Similarly, you cannot record a provision for restructuring costs before you have a legal or constructive obligation in place.

6. Is it reasonable to take the view "the more uncertain the environment, then more detailed disclosures of the assumptions and assessments used to prepare the financial statements should be made"?

In our view, yes it is reasonable. Those preparing financial statements should always be mindful of who will be reading them and how they might be used. The financial statements need to provide enough transparency to enable users to understand the key assumptions that have been adopted so that they can make their own assessment of their reasonableness. While not exhaustive, below are some examples of how COVID-19 will impact the judgements entities make:

How is COVID-19 likely to impact the discount rate used for the impairment assessment?
It's likely to be far more challenging to estimate the discount rate for value-in-use calculations. The current volatility in financial markets introduces additional challenges to this process as the parameters used to estimate discount rates become more unpredictable. Values for assumptions which were somewhat settled in the past, such as the use of long-term government bond yields as a proxy for the risk-free rate, may no longer be appropriate. This means that, more than ever, discount rates need to be assessed after a thorough review of:

- current market conditions
- any guidance provided by market evidence of value for comparable companies or assets
- the risks of the asset or CGU for which recoverable amount is being estimated.

How will it impact the cash flow forecasts?
Entities with reporting dates near the outset of the COVID-19 pandemic are likely to have real challenges reflecting the expected impact on forecast cashflows. While the starting point is that entities are required to determine amounts based on their knowledge of events at the reporting date, not after it, information obtained after the reporting date can only be used to the extent it provides more evidence about conditions at the reporting date.

Significant professional judgement of all relevant facts and circumstances will be required to make this assessment.

The valuation approach required by IAS 36 'Impairment of Assets' also requires careful application to ensure cash flow and discount rate concepts are aligned and so no double counting of COVID-19 risks occur.

What about useful life?
While value-in-use cash flow forecasts are generally required to be for no more than five years, the impact of COVID-19 may mean that companies will now be forced to use the asset in its current condition for a period extending well beyond that. This means a longer forecast period may instead be appropriate. Conversely, long term growth rate assumptions applied previously may no longer be suitable, particularly if the economic impact of COVID-19 is viewed as being more than short-lived.

Cash flow projections must also relate to the asset in its current condition – this means management may need to demonstrate that any forecast improvements in the financial performance of an asset or cash generating unit (CGU) as a result of restructuring and/or re-organisation are due to COVID-19 impacts on the asset in its current condition and not to an underlying improvement in the asset.

7. When assessing expected credit losses (ECL), what should be taken into consideration?

Again, any assessment being made should only be based on information that existed at the reporting date. The expectation set out in IFRS 9 'Financial Instruments' is that past events, current conditions and the forecast of future economic conditions for any financial asset that is not measured at fair value is fairly presented in the financial statements in accordance with the requirements of IFRS 7 'Financial Instruments: Disclosures'. ECL is a probability weighted amount that should be determined by evaluating a range of possible outcomes and the time value of money. This is often overlooked. To make this assessment often takes a considerable amount of time and professional judgment. In responding to the likely deterioration of credit, consideration must also be given to the support packages that are being given by governments and central banks around the world. If there is uncertainty about the extent and applicability of support available to the reporting entity, then our view is that this should be disclosed. Below is a simple example of an ECL disclosure focussing solely on trade receivables (which would supplement the other disclosures required by IFRS 7). Entities with more complex financial instruments should be prepared to disclose considerably more.

The ECL at 31 December 2019 was estimated based on a range of forecast economic conditions as at that date.

Since early January 2020, the coronavirus outbreak has spread across mainland China and beyond, causing disruption to business and economic activity. It will have an immediate impact on the economic scenarios used for ECL, as key inputs for calculating ECL such as GDP are weakening, and the probability of a particular adverse economic scenario for the short term is higher. The impact on GDP and other key indicators will be considered when determining the severity and likelihood of downside economic scenarios that will be used to estimate ECL under IFRS 9 in 2020.

Since the beginning of January 2020, the coronavirus outbreak has caused disruption to our staff, suppliers and customers, particularly in [**<Tailor as appropriate>** *Hong Kong and mainland China.*] The outlook remains uncertain and we continue to monitor the situation closely.

Depending on the duration of the disruption caused by the virus, our results could be adversely affected by increased ECL, lower revenue and market volatility in our business. Further ECL could arise from other parts of our business impacted by the disruption to supply chains.

We have also developed a number of additional scenarios to capture more extreme downside risks and have used these in impairment testing and measuring and to assess our capital resilience. While our economic scenarios used to calculate our ECL capture a range of outcomes, the potential economic impact of the coronavirus was not explicitly considered at the year-end due to the limited information and emergent nature of the outbreak in December 2019.

8. What should be taken into consideration when determining fair values at a reporting date?

The relevant accounting standard is IFRS 13 'Fair Value Measurement' and it states the fair value of an asset or a liability at a measurement date is a specific exit price estimate that is based on assumptions (including those about risks) that market participants would make under current market conditions. Put another way: at the reporting date, what assumptions would market participants have made using all available information, including information that may be obtained through due diligence efforts that are usual and customary?

In some cases greater use of unobservable inputs will be required because some markets have become less active such that relevant observable inputs are not available. However, if a quoted price in an active market (a so-called level 1 price) is available then that price must be used, even if the market has become less active and/or prices more volatile. The key point to recognise is that the fair value measurement objective remains the same, ie an exit price at the measurement date from the perspective of a market participant.

9. How much attention needs to be given to going concern for COVID-19?

A considerable amount. In assessing whether the going concern assumption is appropriate, an entity is required to consider all available information about the future, which is at least, but not limited to, twelve months from the reporting date of financial statements for issue. IAS 1 requires that this assessment takes into account events after the reporting date. One downside is that the longer it takes an entity to complete their financial statements after its reporting date, the more information they need to take into consideration. So if the business is being audited, it should work very closely with its auditor to agree the level of analysis and evidence that is appropriate to support whatever going concern assumption is made.

A key component of assessing going concern is to report all the material uncertainties that exist at the date of approval of the financial statements in a clear and concise way. In some instances there may only be one factor, in other situations there could be a number of them. Preparers of financial statements need to be mindful that under ISA 570 'Going Concern', the auditor is required to make reference to the specific note that appears in the financial statements in their audit report. So this will require the auditor to secure sufficient appropriate audit evidence to confirm all assumptions made in relation to going concern.

10. Ultimately, what impacts of COVID 19 will the users of the financial statements be most interested in?

For many entities, it will be how they have coped with the outbreak so far. Their focus should be on disclosing in their financial statements what steps have been taken to contain and minimise the impact of this global event on their operations. Almost every entity with a 31 December 2019 reporting date is likely to conclude that this outbreak is a non-adjusting event – but that does not absolve it from fully disclosing the post-reporting date consequences on the organisation and its future operations and activities. However, if your entity has a later reporting date, say 31 March 2020, then adjustments to the carrying amounts included in your financial statements will almost certainly be required if the entity is in a position to quantify then. If not, then this should be disclosed as well because the objective of preparing any set of financial statements should be to provide readers with insight not only on the entity's past activity, but also its current operating situation and its future viability.

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