Applying IFRS Standards in 2020—impact of covid-19

Mary Tokar
IASB Member

Sid Kumar
IASB Technical Staff

In this article, member of the International Accounting Standards Board (Board) Mary Tokar and Technical Staff member Sid Kumar provide an overview of some financial reporting considerations for preparers, auditors, investors and regulators as they tackle the complexities associated with covid-19 induced disruptions.

The article draws on the views of an interdisciplinary panel on 'Applying IFRS Standards in 2020—impact of covid-19' at the IFRS Virtual Conference 2020 in September.

The panel focused on:

- what entities need to consider when developing assumptions in preparing financial statements in times of heightened uncertainty; and
- what information to disclose about the assumptions used.

Introduction – Setting the scene

The year 2020 has witnessed the 21st century's most extreme economic crisis. Unlike the recessions occurring in the past two decades, this crisis is the result of a pandemic caused by the coronavirus (covid-19). For most entities, operating in a challenging economic environment amid heightened uncertainty has added to the complexities in reporting the impact of covid-19 in their financial statements.

What are the panel's messages for applying IFRS Standards in 2020?

The panel explored challenges that entities face in preparing their financial statements; auditors face when auditing this information; and investors face in making decisions based on the reported information. The panel discussed some principles to consider.

- users of financial statements (users) expect entities to base their estimates in financial statements on assumptions consistent with management's expectations of business performance and the operating environment at the reporting date.
- these assumptions should be developed using reasonable and supportable information available to management.
- users expect transparency into the key assumptions used. Entities should provide unbiased and clear information about the key assumptions.

Reporting information in this manner allows users to understand the extent to which the financial results can help them in making predictions about the future.

IFRS

Making estimates amid uncertainty and incorporating changing expectations

The panel discussed a few questions on preparing, auditing, and analysing the estimates in the financial statements in a time of heightened uncertainty.

What does an uncertain future mean for making estimates in the financial statements?

Uncertain environments make estimating several items in the financial statements more challenging for entities. For instance, management uses projections of future cash flows when testing for impairment of non-financial assets like goodwill; recognising and measuring the impairment of financial assets; assessing whether the going concern basis of preparation is appropriate; and measuring the fair value of financial assets. With heightened uncertainty about the future, management may find making some of these estimates more challenging than in other years.

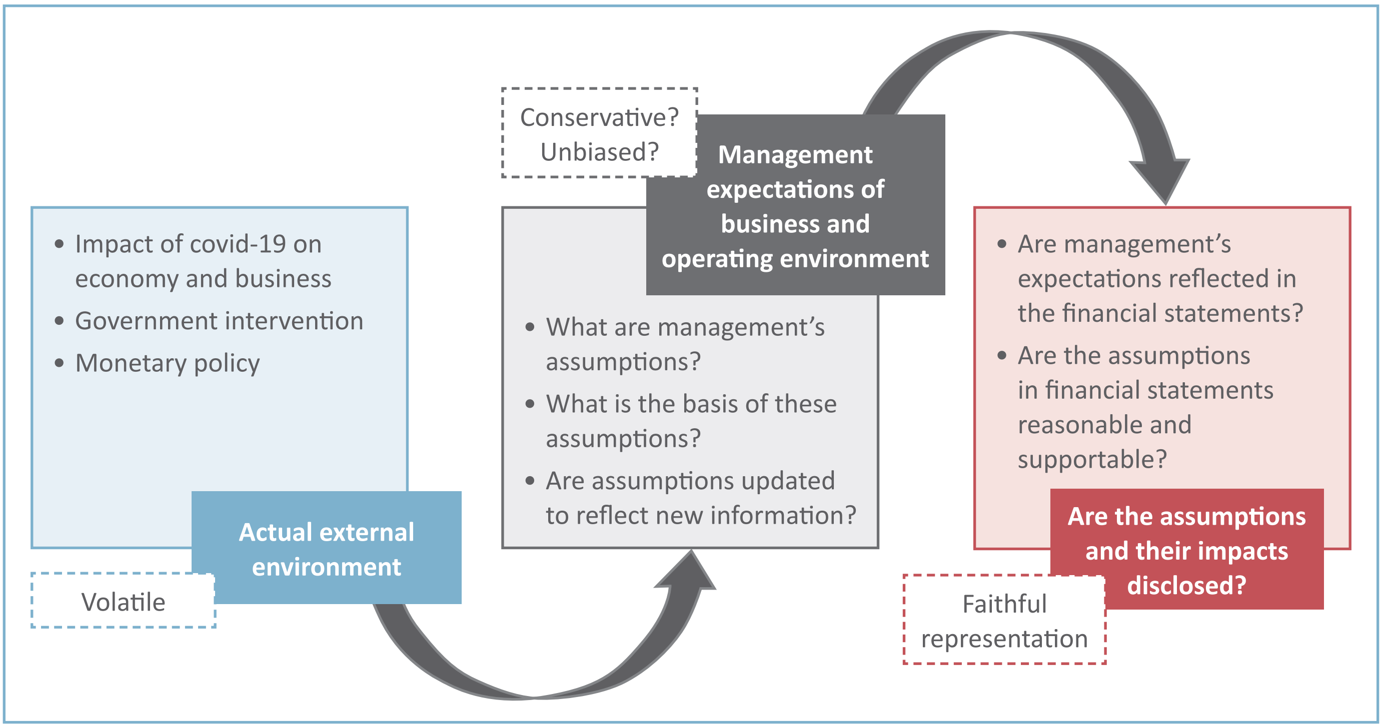
What are some challenges associated with frequently changing expectations?

A high degree of uncertainty in an entity's operating environment is likely to result in more frequent changes in management's expectations about the future. Changes in the external environment (for example, new lockdown measures, or relaxation of such measures) are likely to trigger updates to management's operating plans. Frequent changes in expectations also create a heightened demand from users for up-to-date information. Management and auditors may be anxious about preparing and auditing the financial statements in such circumstances.

Panel members noted that the increase in uncertainty is not a reason to 'freeze' estimates at pre-covid-19 period amounts, and that despite the difficult environment, estimates still need to be updated. Panel members noted that management should take ownership of the estimates used in the financial statements; they also expect that management has robust processes to provide appropriate evidence and bases for these estimates.

The following chart shows an expected approach when incorporating changing expectations in financial statements.

Chart 1: Incorporating changing expectations



Won’t regulators and auditors just end up using hindsight and second-guessing management estimates?

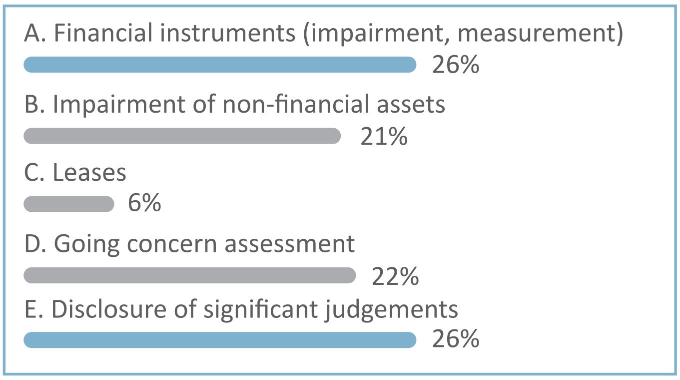
Robust and timely challenge from directors with oversight responsibility, as well as external auditors, is necessary and healthy, however management may be concerned about being second-guessed with hindsight months later. Global securities [regulators have issued a statement]() acknowledging that it is not wrong to use potentially imperfect information in the preparation of financial statements, as long as management use the best available information in making well-reasoned and supported judgements.

Panel members noted that the best way for management to avoid being second guessed is to have a robust process for developing assumptions that includes timely review and challenge both internally (eg by the audit committee) and externally (by auditors).

What about the risk that actual outcomes could be different from the estimates?

Some national standard-setters have stepped in to provide non-authoritative guidance to support entities in developing their best estimates; with greater user needs for information, standard-setters are also reminding entities to disclose their assumptions. Panel members noted that an actual outcome that differs from an estimate is likely in times of heightened uncertainty and does not mean the estimate was an error. The panel also highlighted the importance of updating and disclosing changes in key assumptions or disclosing the continuity of the old assumptions.

Chart 2: Result of polling question on the financial reporting issues that conference attendees found most challenging to deal with because of covid-19



What assumptions should an entity use in a time of heightened uncertainty?

Panel members highlighted expectations that assumptions be:

- guided by faithful application of relevant standards;
- based on the best available, reasonable and supportable information;
- consistent with management’s rationale for the entity’s operations, prospects and viability; and
- derived from a thorough and well-governed process with appropriate oversight from the audit committee and the board of directors.

What did we hear from stakeholders attending the panel discussion?

During the panel discussion, the attendees (of which preparers were identified as the largest stakeholder group) were polled about the financial reporting issue they thought was the most challenging in this period of uncertainty. The respondents identified impairment of financial assets and disclosure of significant judgements as the most challenging.

The poll results were not surprising—the Board has received numerous questions related to the application of IFRS 9 *Financial Instruments* during the pandemic. In response to these questions, in March 2020, educational material was published reiterating the requirements in IFRS 9 on the expected credit losses (ECL) model (see [IFRS 9 and covid-19—accounting for expected credit losses]()). The educational material emphasised that entities should use all reasonable and supportable information that is available to an entity without undue cost or effort when applying IFRS 9, instead of relying on some mechanistic criterion (for example, treating payment holidays as automatic evidence of a significant increase in credit risk) to determine movements in ECL.

Focusing on disclosures

Entities need to supplement rigour in assumptions and estimates with transparency. The panel explored questions that preparers, auditors, and investors may have about disclosure of information.

Disclosure requirements in IFRS Standards

The panel discussed disclosure requirements about assumptions and estimates for both annual and interim financial statements. For entities that report at the end of the calendar year, the impact of covid-19 was first a reporting issue in their interim financial statement. IAS 34 *Interim Reporting* requires entities to disclose significant changes to assumptions and the effect of changes on the financial statements in comparison to those reported in the previous annual period.

Interim reporting

Entities are required to disclose significant changes from the previous year (see IAS 34 15–16A), for example, in relation to:

- impairment of non-financial assets;
- impairment of financial assets (ECLs);
- going concern uncertainties; and
- fair value measurements—Level 3

IAS 1 *Presentation of Financial Statements* requires entities to disclose information about both the judgements made that have the most significant effect on amounts recognised and assumptions and other major sources of estimation uncertainty that have a significant risk of resulting in material adjustments within the next financial year. The panel noted that users may expect entities to disclose not just the general assumptions (for example, macro-economic assumptions about GDP growth and unemployment) and how these assumptions have changed from the previous reporting period, but also the entity-specific impact of these assumptions. Panel members commented that users are also trying to understand what other reasonably possible assumptions management considered and what the impact of using such alternative assumptions might have been on the financial statements. With such information, users can understand the judgements involved and make their own assessment of future outcomes to make better comparisons between entities.

How should entities think about users' information needs—an illustration

The panel discussed the importance of better information about significant assumptions taking the example of expected credit losses (ECL) in IFRS 9 *Financial Instruments*. An ECL approach requires lenders such as banks to use forward-looking macro-economic assumptions (like GDP growth, unemployment rates, housing price changes, etc.) as inputs in models. These assumptions may be classified as general assumptions by some stakeholders because they may relate to factors outside the bank's control. In contrast, entity-specific assumptions relate to an entity's actions (for example, the decision to lend to a vulnerable sector or borrower) and characteristics (for example, its customer base).

When two similar banks use similar general assumptions (for example, about the path of economic recovery) and arrive at different ECL balances relative to their gross loan books (a ratio commonly referred to as a coverage ratio), users want additional information so they can assess the differences in the coverage ratios. For each bank, users want information that helps them understand the extent to which each ECL balance is driven by general assumptions or by entity-specific assumptions that may reflect differences in customer characteristics (for example, retail versus commercial), loan products, collateral, or other loan terms. Without this information, users find it challenging to make meaningful comparisons. The requirements in IFRS 7 *Financial Instruments: Disclosures* were developed considering user needs and IFRS 7 requires entities to explain the factors that affect measurement of their ECLs.

What information do users expect entities to provide about assumptions?

Users want to know what assumptions are used in the current results; how they may or may not have changed from previous reporting periods; and the extent to which these assumptions are consistent with information being used by management to make decisions about managing the business.

What information about assumptions should an entity consider disclosing in the financial statements?

Panel members highlighted their expectations, which included disclosing when relevant:

- key assumptions used;
- changes in assumptions from the last reporting period;
- the impact of changes in assumptions from the last reporting period on the amounts in the financial statements;
- the use of judgement (for example, other assumptions management considered and reasons it opted not to use them); and
- sensitivities to key assumptions.

Covid-19 and non-GAAP financial measures

In addition to talking about developing and updating assumptions used to prepare financial statements, the panel also commented about the use of non-GAAP performance measures, which in some jurisdictions might supplement financial statements[1]. Users and regulators can be wary of non-GAAP performance measures such as adjusted profit or loss sub-totals, especially if these are based on estimates of 'missing' revenue. User scepticism for such measures is heightened in times of crisis when management may be under greater pressure to make use of adjustments to soften reported under-performance. The global securities regulators' statement on reporting in the time of covid-19 explains that entities need to avoid obscuring their performance presentation by using non-GAAP performance measures. It may be inappropriate for entities to use such measures without providing a reasonable basis for the adjustments as well as providing a clear explanation of the purpose of presenting such measures.

Chart 3: Top tips from the panel for reporting in times of heightened uncertainty

Clarity	Transparency	Context
• Tell it like it is • Highlight changes from year-end	• Consistency with basis for management decisions • Focus on the big picture and whether the short term is indicative	• What assumptions have been made • Level of uncertainty in assumptions • Update for most current information

1 The IASB recently proposed adding requirements regarding certain management performance measures to its standards.

Summary

This article highlights some challenges in preparing, auditing, and analysing the financial statements in a time of heightened uncertainty.

It is difficult to predict when the covid-19 induced economic crisis will end, and until then, entities will have to continue to operate in an uncertain environment. Unending uncertainty creates a greater need for clear, transparent, and contextual information in the financial statements.

Most attendees at the conference session agreed that disclosure requirements in IFRS Standards are satisfactory but that improvements are needed in their application. Providing clarity amid uncertain conditions is not only necessary but also valued. Uncertainty does not suspend the need to make and update estimates.

57% of those attending the conference session agreed with the following statement about disclosing the impact of covid-19

"Existing disclosure requirements don't need to change but improved application of the disclosure requirements is needed (by preparers, auditors, and enforcers)"

The IFRS Foundation thanks the panel members who shared their views and experience, speaking in a personal capacity and not on behalf of their organisations.

- Tadeu Cendon (International Accounting Standards Board member)
- Florian Esterer (Bank J Safra Sarasin, Capital Markets Advisory Committee member)
- Yasunobu Kawanishi (Accounting Standards Board of Japan, chair of International Forum of Accounting Standard Setters)
- Paul Munter (US Securities Exchange Commission staff)

Get in touch

If you would like to discuss this topic or other areas of accounting, please contact Fred Nieto, Technical Staff – Stakeholder Engagement, at fnieto@ifrs.org.

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