COVID-19 | Are fair values appropriately determined and disclosed?

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What's the issue?

The COVID-19 coronavirus pandemic significantly affected economic activity and financial markets in 2020 and continued to have repercussions in 2021. For many assets and liabilities, fair values may have changed significantly, reflecting changes in cash flow forecasts, higher uncertainty and elevated risks. Performing a valuation in these market conditions is more challenging, in particular when significant unobservable inputs are used.

Fair value is a market-based measurement – it is measured using assumptions that market participants would use, reflecting market conditions at the measurement date. According to IFRS 13 *Fair Value Measurement*, a quoted price in an active market provides the most reliable evidence of fair value and if one is available then it has to be used to measure fair value. Use of hindsight or adjusting for what may be viewed as depressed pricing at the measurement date in light of subsequent changes in market prices is not permitted. *[IFRS 13.77, 79]*

Getting into more detail

'Unobservable inputs' are inputs for which market data is not available and that are developed using the best information available about the assumptions that market participants would make in pricing the asset or liability, including assumptions about risk. Unobservable inputs used in valuations may require significant adjustment to reflect the risks and uncertain market conditions at the measurement date. *[IFRS 13.A]*

Greater estimation uncertainty and less observable market data may require companies to change valuation techniques and use more judgement and assumptions. This may lead to a higher number of fair value measurements classified as Level 3 in the fair value hierarchy – e.g. due to unobservable inputs becoming significant in the continuing pandemic environment.

"The number of significant unobservable inputs may have increased – this may lead to a higher number of Level 3 measurements and with it to more disclosures that are required by IFRS 13."

Reflecting risks and market conditions at the measurement date

Some of the key factors and risks to consider when measuring fair value using a valuation technique include the following.

- **Economic activity levels.** Measures taken to contain the virus may lead to a significant reduction in economic activity in terms of production of and demand for goods and services, and may have a negative impact on forecast future cash flows used in a discounted cash flow valuation method. The effects on different sectors of the economy have varied significantly – e.g. companies in the transportation and leisure sectors continue to be more adversely affected than the technology and telecommunications sectors.

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- **Credit risk and liquidity risk**. The uncertain economic environment has resulted in increases in credit risk and liquidity risk for some companies. Own credit risk and/or counterparty credit risk used as inputs into valuation techniques may therefore increase.
- **Forecasting risk.** Fair value measurements should reflect the greater uncertainty in making economic and financial forecasts in the near term, due to the difficulty in forecasting the magnitude and duration of the economic impact of COVID-19. Companies need to be wary of anticipating economic recovery too soon in their cash flow forecasts given the prolonged nature of the pandemic.
- **Foreign exchange risk**. Companies with significant sales or purchases in foreign currencies may be adversely affected by exchange rate movements.
- **Commodity price risk.** Companies in extractive industries may be significantly affected by decreases in the prices of certain commodities.

Significant judgement may be needed to quantify risk premiums and other adjustments for these risks. Incorporating other specific effects of the pandemic – e.g. support measures from the state or international organisations, including the potential effects of the withdrawal thereof, may require significant judgement as well.

This increases the importance of providing disclosures around the key assumptions and judgements used, to help users of financial statements understand the impact of COVID-19 on a company's fair value measurements.

What do you need to disclose?

Disclosures related to fair value measurement are likely to be a focus area for regulators. Preparers are expected to explain how COVID-19 has affected significant judgements and estimation uncertainty – e.g. the assumptions underlying fair value measurement. In a recent statement ESMA1[1], the European regulator, strongly recommends that companies provide information about the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculations. For more information, see our **article** on ESMA's enforcement priorities for 2021.

Annual reports

Given the impact of economic uncertainty on forecasting cash flows and other unobservable inputs used in valuation techniques (e.g. certain risk-adjusted discount rates), companies may need to provide sensitivity disclosures – together with disclosure of the key assumptions and judgements made by management – to enable users to understand how fair value has been determined. These disclosures are required under both IFRS 13 and IAS 1 *Presentation of Financial Statements*. IFRS 13 also contains specific disclosure requirements when amounts are transferred into Level 3 of the fair value hierarchy. *[IFRS 13.93(e)(iv), 93(h), IAS 1.125, 129]*

Interim reports

IAS 34 *Interim Financial Reporting* requires companies to provide many of the IFRS 13 disclosures on fair value measurements of financial instruments, including the sensitivity disclosures and significant transfers between levels in the fair value hierarchy. Additionally, IAS 34 requires companies to explain events and transactions that are significant to an understanding of the changes in a company's financial position and performance since the last annual reporting date. Therefore, fair value disclosures related to non-financial assets and non-financial liabilities are required if they are material to an understanding of the current interim period. This may be the case when fair values change significantly. *[IAS 34.15, 16A(j)]*

Our annual **Guides to financial statements**, which help you to prepare financial statements under IFRS® Standards, include a **COVID-19 supplement** illustrating additional disclosures that companies may need to provide on accounting issues arising from the pandemic.

1 European Securities and Markets Authority

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Recovery from the pandemic – Impacts on fair value measurement

Many countries are starting to recover from the pandemic and are experiencing a fast recovery in demand for certain goods and services. However, the rate of recovery may not be the same across all sectors – e.g. in transportation and hospitality sectors. Because this renewed economic activity has generally improved the availability of observable market data, fewer assets and liabilities might now be classified as Level 3 in the fair value hierarchy.

Actions for management to take now

Consider whether the valuation:

- reflects market participants' assumptions based on information available and market conditions at the measurement date;
- technique used is maximising the use of relevant observable inputs and minimising the use of unobservable inputs; and
- incorporates the risk premiums that would arise from the uncertainty and other impacts of COVID-19.

Consider whether unobservable inputs have become significant, which would result in a Level 3 categorisation and require additional disclosures.

Consider expanding disclosures about the key assumptions, sensitivities and major sources of estimation uncertainty.

References to 'Insights' mean our publication **Insights into IFRS**

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