INSTITUT DER WIRTSCHAFTSPRÜFER

30.09.2022

IMPORTANT NOTICE: This document provides an unofficial convenience translation of a German publication. Solely the German original, which can be accessed from the IDW website, is valid. The IDW has not performed any check as to the quality of the translation and consequently does not accept any responsibly whatsoever for this English language translation.

Development of the economic environment and effects on financial statements as of or after Sept. 30, 2022

Technical guidance by the IDW

1. Preliminary remarks

Society, politics and the economy are currently facing multi-layered, in part interdependent challenges that give rise to severe uncertainties and risks:[1]

- Russia's war against Ukraine,
- trade restrictions and sanctions,
- energy supply bottlenecks, distortions on the energy markets and rising energy costs,
- supply chain bottlenecks (e.g., due to Corona-related lockdowns in China or other disruptions in transport routes),
- high inflation rates, rising interest rates and devaluations of the euro,
- climate risks,
- onerous and further pressures from the corona pandemic,
- labor shortage,

[1] See, inter alia, ESMA, Reports on Trends, Risks and Vulnerabilities, No. 2 / 2022.

- the further development of the relationship between China and the Western world, and
- an expected recession in Europe and Germany.

In its current monthly report for September 2022 (as of September 16, 2022), the German Bundesbank also determined that "there are increasing signs of *a recession in the German economy in the sense of a significant, broad-based and prolonged decline in economic output."*[2] . Meanwhile, fundamental data show deterioration. The number of insolvencies rose by 6.6% in August compared with July 2022.[3] The ifo business climate index fell further in September 2022. The ifo Institute determined that the mood in the German economy is poor and the outlook for the coming months is clearly pessimistic.[4] Due to increased credit risks, banks are currently tightening credit guidelines, especially for corporate and housing loans.[5] Overall, the risk situation is currently being represented as more severe - also in comparison with June 30, 2022. Whether this trend continues will depend, among other things, on how government support for consumers and companies is structured both in its entirety and on a sector-specific basis, and what impact it has - both directly and indirectly. The German government is currently working on a new billion-euro aid program.

Companies are addressing the challenges and developing measures to counter the risk situation and reflect its (expected) impacts in their financial statements as well as the disclosures made in the notes and their management reports. Depending on the industry and business model, the risks have different significance for the reporting companies, with energy-intensive industries, in particular, being under severe pressure. In many instances, it is impossible to extrapolate past experience into the future.

For example, companies' valuation models may need to be further developed in order to reflect the complex uncertainties appropriately. In many cases, the uncertainties make it difficult to forecast the further development of the company. Corporate planning, in turn, is relevant for a large number of accounting issues, e.g., the executive directors' estimates relating to continuation of business activities, goodwill accounting, valuation of investments as well as accounting for provisions and deferred taxes.

With this Technical Guidance, the IDW provides specific support on accounting and reporting issues under both IFRS and HGB for financial statements as at September 30, 2022 and for subsequent reporting dates (in particular, December 31, 2022). Depending on further developments, the IDW will issue additional material where required. On March 8, 2022 (most recently supplemented on August 9, 2022) and July 18, 2022, the IDW had already published

[2] Deutsche Bundesbank, Monthly Report September 2022, p. 5.

[3] See Federal Statistical Office, press release No. 382, Sept. 12, 2022.

[4] See ifo Institute, ifo Business Climate Germany, Results of the ifo Business Surveys in September 2022.

[5] See Deutsche Bundesbank, Monthly Report August 2022, p. 36.

extensive Technical Guidance on the impact of the Ukraine war on the financial statements and their audit, parts of which are referred to below.[6]

Not every company will be affected by the topics discussed below. The extent of the impact of particular issues also varies depending on, amongst other things, the business activities, the industry and the environment in which a company operates; it is therefore not possible to make general assertions. A company-specific evaluation is essential in each case.

2. Effects of uncertainties on forecasts

Corporate planning is the basis for forecasting cash flows and determining input factors (e.g., growth rates) relevant to numerous accounting and measurement issues.

In general, the following applies: Forecasts must be based on reasonable assumptions by management, placing greater emphasis on external indications. They must be revised in the event of new developments. **Owing to the risk situation, it will often not be possible to continue unchanged with assumptions based on the past.**

In addition, forecasts of cash flows and estimates must be plausible, coherent and comprehensible to third parties across all financial statement items and components. The greater the uncertainties facing a company preparing financial statements, the more difficult corporate planning becomes. This may be countered by, among other things, the creation of various scenarios and increased transparency through pervasive disclosures for users of financial statements (e.g., in the form of sensitivity analyses).

The following aspects should be emphasized once again:

- Current events will increase the pressure on capitalized **goodwill.** The present value calculation of the comparative value to be compared with the most recent carrying amount is reduced both by any dampened expectations of earnings or cash flow (in the numerator) and by rising discount rates (in the denominator). When calculating the discount rate under high inflation particular attention must be paid to the consistent use of nominal values or real values in the numerator and denominator.
- According to IAS 36, which is relevant for determining any need for impairment in international accounting standards, the estimation of future cash flows, for example, is decisive for determining the value in use. Of particular importance is the determination of the present value of the **terminal value**. It reflects the value of an asset or a cash-generating unit after the end of the detailed planning period (i.e., the period to which the most recent

[6] See https://www.idw.de/idw/themen-und-branchen/russland-ukraine-krieg. For convenience translation (Stand 2nd Update, April 2022) into English see: Down-Ukraine-IDW-FachlHinw-ReLe-Pruefung-Maer22-English (1).pdf uefung-Apr22-English.pdf

financial plans/forecasts relate) and is based on a long-term extrapolation of trend developments. However, the last planning year shall not be used for calculation of the perpetuity phase without due reflection.

The same applies to the determination of a lower of cost or market value based on future income extrapolation in financial statements prepared in accordance with [German] commercial law, e.g., in the case of patents or similar rights and long-term equity investments.

- Forecasts are also regularly indispensable for the recognition of **deferred tax assets** resulting from deductible temporary differences and for the carryforward of unused tax losses. Recognition is only permitted if it is probable that future taxable profit will be available against which the deductible temporary differences or the unused tax losses can be utilised. For accounting under [German] commercial law, a particularly critical question is whether the tax losses carried forward – to the extent that they are not offset by passive differences – can be utilized within the next five years (Article 274, Paragraph 1, Sentence 4 HGB [Handelsgesetzbuch: German Commercial Code], GAS (German Accounting Standard] 18.18 et seq.).
- According to IAS 37, the measurement of provisions is to be based on the **best estimate** of the expenditure required to settle the present obligation at the end of the reporting period. The estimates of outcome and financial effect are determined by the judgement of the management of the entity and must be reviewed at each date of the financial statements and revised as necessary (e.g., due to cost increases, changes in interest rates, etc.). Future price and cost increases must be taken into account.
- Under [German] commercial law accounting, provisions are to be recognised in the ***amount necessary to settle the obligation in accordance with prudent*** commercial evaluation (Article 253, Paragraph 1, Sentence 2, HGB). Consequently, as under IFRS, measurement shall not be based on the current price and cost ratios applicable on the date of the financial statements, but instead on the future price and cost ratios foreseeable from the perspective of the date of the financial statements at the point in time when the relevant liability is expected to be fulfilled. Inflation must therefore be taken into account in measurement. The determination of foreseeable price and cost changes shall be based primarily on company- and industry-specific data (*IDW RS HFA 34 [IDW Accounting Standard HFA 34]*, para. 27). This applies equally to other provisions and to pension provisions. In the case of the latter – subject to Article 16, Paragraph 3, BetrAVG [Betriebsrentengesetz: German Occupational Pensions Act] – expected inflation-induced wage, salary and pension increases must be taken into account.
- As a result of the outbreak of war **provisions for expected losses from executory contracts may be required, in particular, for pending sales transactions at the date of the financial statements** with agreed fixed fees; but such provisions may also and

especially, be required as a result of war-related increases in energy prices and in the prices of certain raw materials or other input factors required for the provision of the company's own contractually owed delivery or other service. A provision for anticipated losses must be recognised if the value of the consideration due to the reporting entity under a synallagmatic contract falls short of the value of the provision of good(s) or other service(s) still to be provided by the reporting entity after the date of the financial statements. If the expected loss from the pending sales transaction relates to assets capitalised as at the date of the financial statements, the expected loss is initially to be recognised by means of a write-down of the assets directly impacted; a provision for expected losses is only to be recognised for a loss exceeding this amount (see in detail *IDW RS HFA 4*)[7] .

3. Recognition and measurement of financial instruments

In its Technical Guidance on the impact of the spread of the coronavirus[8] and the Ukraine war[9] on the financial statements and their audit, the IDW has already addressed numerous topics and issues potentially relevant to the accounting for, and measurement of financial instruments. These continue to be relevant in the current political and economic environment.

For financial statements dated as at or after September 30, 2022, the IDW once again draws attention to the following selected accounting and valuation topics:

<u>Impairment (IFRS)</u>

- Particular attention must be paid when accounting for financial instruments in accordance with IFRS 9[10] to the evaluation of a **significant increase in credit risk (SICR)** and thus any required bucket transition (e.g., from bucket I to bucket II). The bucket transition is based on consideration of reasonable and supportable information about past events, current conditions and forecasts of future economic conditions with regard to their effect on credit risk.

---

[7] For the recognition of provisions for expected losses from executory contracts in accordance with IAS 37, see the answer to question 4.5.1. of the IDW's Technical Guidance dated March 8, 2022 (last amended on August 9, 2022).

[8] See most recently IDW, Technical Note "Questions concerning the impact of the spread of coronavirus on the financial statements and their audit" (5th update, April 2021). A convenience translation int English is available: Down-Corona-IDW-FachlHinw-ReLePruefung-Teil3englisch.pdf

[9] See IDW, Technical Guidance dated March 8, 2022 (last supplemented on August 9, 2022), p. 16 et seq. (HGB) and p. 33 et seq. (IFRS).

[10] Insurance companies that do not (yet) prepare their accounts in accordance with IFRS 9, but in accordance with IAS 39, must assess at the end of each reporting period whether there is any objective evidence that a financial asset (or a group of financial assets) is impaired. For detailed information, please refer to the IDW's Technical Guidance on the war in Ukraine dated March 8, 2022 (see question 4.3.2.9) and the *IDW's statement on financial reporting: Einzelfragen zur Bilanzierung von Financial Instruments in accordance with IFRS (IDW RS HFA 9)* (as of May 13, 2016), section 6.

- Extreme dynamic situations such as the current war and its (potential) aftermath, or the corona pandemic, give rise to considerable estimation uncertainty and discretion that must be exercised appropriately. A **transparent presentation of the exercise of discretion** and the assumptions on which estimates are based, as well as the sources of estimation uncertainty must be provided in the notes to the financial statements. This also applies to issues relating to the determination of the amount of expected credit losses.
- The **estimation of expected cash flows to be undertaken when determining expected credit losses should take into account** and represent various scenarios in order to adequately take the existing uncertainties into consideration. The determination of relevant **scenarios**, their likelihood of occurrence, and also the granularity of the risk factors play a decisive role here. The geographical region and industry-specific aspects are of particular importance in the risk assessment (see in detail *IDW RS HFA 48*).
- Current and forward-looking information must also be taken into account when calculating expected credit losses for **trade receivables** under the *simplified approach.* In the case of the use of *provision matrices,* the provision rates used, which are regularly derived from the past experience of the reporting companies, must be critically assessed in light of the current situation, and revised if necessary.
- If uncertainties or existing risks could not be adequately taken into account at the end of the reporting period by applying established valuation models, these are reflected in practice by means of **post-model adjustments**/overlays. During the corona pandemic, (credit) institutions in particular used this way to increase the loss allowance already calculated. When determining the amount of post-model adjustments, care must be taken to ensure a sufficient analysis of the causes so that, for example, existing corona pandemic-related post-model adjustments can be distinguished and justified as distinct from new post-model adjustments that become necessary as a result of the war in Ukraine. When deciding to make post-model adjustments, it is necessary to define not only the reasons for their formation but also the circumstances in which amounts not used up to that point are to be reversed should the reasons for their formation no longer apply.

Impairment test (HGB)

- For information on the aspects to be taken into account in subsequent measurement for the various categories of **financial instruments held as fixed assets, please refer to the comments** in the IDW's Technical Guidance on the Ukraine War[11] , which apply to all financial statements dated after the start of the war, and to the VFA's [Versicherungsfachausschuss - Insurance Technical Committee] Technical Note[12] on the subsequent measurement of investments.
- Debtors of the reporting entity may experience financial difficulties as a result of the current crisis, as a result of which the risk of default (or of not being able to fulfill **trade receivables** in full or on time) has increased (possibly significantly). This must be taken into account, independent of the expected permanence of the loss allowance for the claim, by writing it down to the lower of cost or market value in accordance with Article 253, Paragraph 4, HGB.

Reclassification (IFRS/ HGB)

- A very high threshold is required for the reclassification of financial assets under **IFRS.** They may only be reclassified in connection with a change in the business model for managing those financial assets. The crises and their impacts as such do not justify reclassification; they may, however, amongst other thing, be the reason for a change in the business model. A reclassification of financial assets requires that the change (a) is determined by the entity's senior management as a result of external or internal changes, (b) is significant to the operations of the entity, and (c) must be demonstrable to external parties.
- In the case of (credit) institutions, **Article 340e, Paragraph 3, Sentences 2 and 3 HGB** precludes the reclassification of financial instruments from other measurement categories *to* the trading portfolio. A reclassification *from* the trading portfolio is only permissible if exceptional circumstances, in particular serious impairments of the tradability of the financial instruments, lead to the institution abandoning its intention to trade the financial instruments in question. A decline in price alone does not impair tradability. This excludes, in particular, reclassifications that should be undertaken solely in order to shape or smooth the annual result, i.e., solely to avoid devaluations.
- Reference is made to *IDW RH [Rechnungslegungshinweis: Accounting Practice Note] HFA 1.014* for the **reclassification** of securities **under German commercial law.**

[11] See IDW, Technical Guidance of 08.03.2022 (last supplemented on 09.08.2022), p. 16 et seq.

[12] See VFA, Fachlicher Hinweis zur handelsrechtlichen Messung von Kapitalanlagen bei Versicherungsunternehmen (currently in progress).

4. Necessity of transparent reporting in the notes and management report

Creating transparency

For all uncertainties, IFRS financial statement preparers must report in the notes on the possible, entity-specific consequences of the current crisis up to the existence of a risk that endangers the existence of the entity, hereby disclosing material accounting policy information and judgements management has made for accounting and reporting purposes. This disclosure must enable users to understand management's considerations and assessments in such a way that they can form their own views of the entity's situation.

In this context, among other things, disclosures on estimation uncertainties must be made, e.g., sensitivity analyses are required (see IAS 1.125 et seq.).[13] If material adjustment effects have occurred during the current reporting period as a result of changes in estimates, this must be reported (see IAS 8.39 and IAS 34.16A(d)).

In the event of material uncertainties, it is appropriate to provide suitable disclosures within HGB financial statements in order to give a true and fair view of the assets-, liabilities, financial position and profit or loss.

Reporting subsequent events in the notes to the financial statements

In accordance with Article 285, No. 33 of the German Commercial Code (HGB), events of particular significance that occurred after the end of the financial year but up to the finalization of the preparation of the financial statements and that are not reflected in either the income statement or the balance sheet must be disclosed in the notes to the financial statements prepared in accordance with [German] commercial law. The nature and financial impacts of the event must be disclosed in this supplementary reporting. In general, an event is of particular significance if its impacts are likely to influence the view given by the financial statements as at the date of the financial statements and if, without the supplementary reporting, the financial statement users' assessments of the development after the date of the financial statements would differ significantly.

Under IFRS, if a so-called non-adjusting event is material, the nature of the event must be reported (IAS 10.21(a)). According to IAS 10.21(b)), an estimate of the financial effect or a statement that such an estimate cannot be made must be disclosed in the notes.

[13] See also ESMA, Public Statement dated May 13, 2022, Implications of Russia's invasion of Ukraine on half-yearly financial reports.

Reporting on risk in the management report

Although the assessment of risks must be undertaken as at the date of the financial statements, if, after the end of the reporting period (up to the finalization of the preparation of the management report), the significance of risks changes, new risks arise or risks cease to exist, the changed assessment of risks must also be disclosed if an appropriate view of the company's risk situation would otherwise not be provided (GAS 20.155).

Reporting on prospective information in the management report

The exceptions given in GAS 20.133 whereby there are lower requirements apply to the accuracy of forecasts regarding the development of the most significant financial and, if applicable, non-financial performance indicators up to the end of the forecast period (namely an exceptionally high level of uncertainty regarding future prospects due to macroeconomic conditions and, at the same time, a significant impairment of the company's ability to forecast) may currently be regarded as fulfilled by many companies; however, due to the different individual ways in which companies are affected, a case-by-case assessment is always required based on the circumstances at the finalization of the preparation of the management report. If the requirements are fulfilled cumulatively, the companies concerned are permitted to provide only comparative forecasts in the management report instead of point, interval or qualified comparative forecasts, or present the expected development of the performance indicators in various future scenarios, stating their respective assumptions in the report. However, it is not permissible to include no forecasts in the management report, even in light of the current high uncertainties.

5. Auditor's report: Including an Emphasis of Matter paragraph related to the uncertainties that exist.

IDW published extensive guidance on the inclusion of an Emphasis of Matter paragraph in the auditor's report in the Technical Guidance on the effects of Russia's war in Ukraine on financial statements and their audit, as well as previously in the Technical Guidance on the impacts of the coronavirus pandemic. Specifically, the following questions were answered:[14]

- Under what circumstances may an Emphasis of Matter Paragraph be included in the auditor's report? When may such a reference not be made?
- How must an emphasis of matter paragraph be designed?
- Is a general reference to uncertainties related to the Corona pandemic useful?

[14] See IDW, Technical Guidance of 08.03.2022 (last supplemented on 09.08.2022), p. 69 et seqq.; IDW, Questions concerning the impact of the spread of coronavirus on financial statements and its audit (Part 3, 5th Update, April 2021), p. 65 et seq. Down-Corona-IDW-FachlHinw-ReLePruefung-Teil3englisch (3).pdf

- In what instances may the inclusion of an emphasis of matter paragraph be appropriate related to the Corona pandemic or current wartime events?

These paragraphs are to be applied analogously to the current situation. The inclusion of a general reference to generally existing uncertainties in the auditor's report does not ordinarily appear to be the appropriate means of taking current events into account.