Chapter 1

COVID-19: Potential impact on financial reporting

This article aims to:

Highlight key accounting and financial reporting impacts of COVID-19 to be considered by companies.

Introduction

The rapid outbreak of the coronavirus (COVID-19) presents an alarming health crisis that the world is grappling with. The impacts of the COVID-19 pandemic are unfolding in real time. The COVID-19 outbreak has already had a significant effect on the economies of affected countries and international financial markets. As the companies in India approach their year-end, there is an urgent need to evaluate the impacts of the outbreak on their accounting and financial reporting.

Key impacts on financial reporting

The financial reporting impacts of the COVID -19 outbreak will depend on facts and circumstances, including the degree to which a company's operations are exposed to the impacts of the outbreak.

Some of the key accounting and financial reporting considerations for the companies are explained below.

Going concern

The outbreak of COVID-19 has caused a significant deterioration in economic conditions for some companies and an increase in economic uncertainty for others.

Management would need to assess whether the current events and conditions cast significant doubt on the company's ability to continue as a going concern, or in severe cases, whether the going concern assumption is still appropriate as a basis for the preparation of the company's financial statements. In many cases, budgets and forecasts that may have been used to support management's initial going concern assessment may now be of limited relevance given the rapidly changing economic and business circumstances and may require significant revision to be able to support management's assessment in the current environment.

It would be critical to understand what impacts current events and conditions have on a company's operations and forecast cash flows, with the key immediate issue being whether the company still has sufficient liquidity to continue to meet its obligations as they fall due.

To the extent the events and conditions are identified that may cast significant doubt on a company's ability to continue as a going concern, disclosure would be required if these events constitute material uncertainties or management's conclusion involved significant judgement (i.e. a 'close call' scenario). Additionally, Ind AS 107, *Financial Instruments: Disclosures* requires disclosure of quantitative data about liquidity risk arising from financial instruments. A company also needs to explain how it is managing this risk, including any changes from the previous period and any concentrations of liquidity risk.

Disclosures addressing these requirements may need to be expanded, with added focus on the company's response to the impact of COVID-19.

Impact on accounting estimates

Various accounting estimates, which depend on future forecasts, could be impacted by the outbreak. Examples of specific areas that may be impacted include:

- **Impairment of non-current assets and goodwill:** Many companies may be facing the problem of low demand for their products or services or may be affected by the restrictions imposed by the government. Certain companies may be dependent on supply chains or may have production facilities in the states in India and abroad affected by lockdown. This situation could be an impairment trigger, and require an impairment test. However, it could be a challenge for many companies to estimate future cash flows due to the increase in economic uncertainty. Also companies would need to ensure that discount rates used in recent valuations have been updated to reflect the risk environment at the reporting date.

  Companies would need to provide disclosures as per Ind AS 36, *Impairment of Assets* and also help users understand uncertainty associated with management's assumptions about the future. Therefore, robust disclosures are needed to understand the degree of estimation uncertainty that exists in estimating the recoverable amount and the sensitivity of the recoverable amount to reasonably possible changes to key assumptions.

- **Onerous contract provisions:** Customer contracts may become onerous if, for example, suppliers are unable to fulfil their obligations under the contract as a result of closure or reduced production by manufacturing plants, which would necessitate recognition of a provision. Delay in fulfilment of contractual obligations may also result in penalties to be provided for. Companies should consider providing meaningful disclosures about judgements and estimates applied in recognising and measuring provisions.

- **Valuation of inventory:** There could be a significant impact on the inventory valuation on account of forced plant shutdowns, decline in net realisable value due to reduction in demand and non-fulfillment of sales and purchase contracts.

- **Expected Credit Losses (ECLs):** Certain sectors and regions may be particularly severely affected by the economic effects of COVID-19. Hence, companies would need to consider the impact of COVID-19 appropriately while recognising ECLs. However, the companies may find it challenging to incorporate into their measurement of ECLs the forward-looking information relating to the economic impact of COVID-19 that is available without undue cost or effort at the reporting date.

  Ind AS 109, *Financial Instruments* requires the application of judgement and both requires and allows entities to adjust their approach to determining ECLs in different circumstances. A number of assumptions and linkages underlying the way ECLs have been implemented to date may no longer hold in the current environment. Companies may need to consider the impact of any prudential regulatory actions taken to sustain the economy such as loan repayment holidays, reduction in interest rates. Additionally, the impact on the business of borrowers could also impact the credit risk parameters such as, risk of default (probability of default), loss given default i.e. estimated amount of the loss in the event of default and exposure at default.

  Relevant disclosures should be provided to enable better understanding of credit risk, timing and uncertainty of future cash flows.

- **Deferred tax assets:** The recoverability of deferred tax assets may be impacted by changes to future forecasts.

- **Insurance claims:** The companies may evaluate the terms of their insurance policies and estimate possible compensation surrounding loss of profits and business disruption, etc. including timing of recognition of such claims.

Fair value assessment

The fair value of an asset (or liability) is determined as per the market conditions at the measurement date. Due to uncertainty of the economic impact of COVID-19, there would be a significant change in the assumptions used to measure fair value of the assets and liabilities of a company at the end of the reporting period including considerable change in the valuation techniques being adopted by the companies on account of change in the market conditions and related observable inputs, redundant previous information, etc. Appropriate disclosures to address the change would become necessary.

As per Ind AS 1, *Presentation of Financial Statements* and Ind AS 113, *Fair Value Measurement,* a company would need to provide sensitivity disclosures along with disclosure of the key assumptions and judgements made by management. This is likely to enable users to understand how fair value has been determined and categorisation of fair value hierarchy.

Revenue recognition

Uncertainty about whether the rights and obligations in customer contracts remain enforceable may affect the timing and amount of revenue to be recognised. Companies and their customers may seek to modify existing contracts to respond to the impacts of COVID-19 on their business. Exercise of judgement would be required to assess when contract modifications are approved, particularly when contracts are modified frequently or there is continuing uncertainty about how a contract will be completed.

Companies would also be required to assess whether assets related to the revenue cycle - e.g. receivables, contract assets, inventories and capitalised contract costs are appropriately measured to reflect the uncertainty created by the outbreak.

Significant judgements and changes to those judgements affecting the amount and timing of revenue recognised should be appropriately disclosed.

Revenue estimates such as variable consideration (discounts, rebates, incentives, etc.) and stand-alone selling prices of goods and services might also need to be updated to reflect the current environment. Expanded disclosures depicting the methods, inputs and assumptions used for estimating variable consideration and stand-alone selling prices would become necessary.

Lease accounting

A company which is a lessee would need to assess its right-of-use assets for impairment. Similarly, lessors would need to ascertain whether some of their underlying assets held for lease are to be considered for impairment due to decrease in demand for such assets or steep decline in rentals. Other impact areas could be determination of lessee's incremental borrowing rate on account of change in its borrowing costs consequent to decline in its credit rating, reassessment of lease contracts including lease term, lease modifications and revenue recognition by lessor.

Also evaluate whether any lease arrangement has become onerous and as a result, a provision need to be recognised.

Hedge accounting

The COVID-19 outbreak may affect when and how a company applies hedge accounting.

In case of cash flow hedge, companies need to evaluate whether forecast transactions continue to be highly probable. If a transaction is not highly probable, then consider whether it is still expected to occur.

Additionally, any changes to the contractual terms of a financial instrument resulting from the COVID-19 outbreak may affect the instrument's eligibility as a hedged item.

Further, the increased credit risk arising from the COVID-19 outbreak could affect both hedge effectiveness testing and the measurement of hedge ineffectiveness. Companies would also need to evaluate whether accumulated losses in the cash flow hedge reserve will be recovered in future periods. If not, then it may have to reclassify the amount of loss not expected to be recovered to the statement of profit and loss.

Relevant disclosures depicting changes in how the company manages risks including impact of hedge ineffectiveness and reclassifications to the statement of profit and loss should be provided.

Derivative accounting

The COVID-19 outbreak could result in significant decline in business activity and subsequent decreases in a company's expected purchase, sale or usage requirements, disruptions to supply chains that may impair a company's ability to effect physical settlement and sudden decreases in demand (or supply) that may cause contracts to be closed out or terminated through net cash settlement without delivery. These circumstances may undermine a company's ability to apply the own use exemption. As a result, a company might need to reassess whether derivative accounting is required for sale and purchase contracts entered into by it.

Internal controls over financial reporting

Companies should also evaluate the effect on internal control over financial reporting, if any. For instance, new controls or modification in controls would be required where companies have enhanced/modified IT access to enable remote workforces.

Employee benefits

Market volatility and changes to remuneration policies may impact how companies estimate and measure employee benefits and recognise share-based payment expenses.

Modifications to share-based payment arrangements will need to be assessed as to whether they are either beneficial or non-beneficial to the employees and accounted for accordingly.

Government grants

Management would need to monitor government actions and legislation to identify all assistance given amid COVID-19 outbreak that may meet the definition of a government grant.

Companies that have not previously received government grants may need to develop new accounting policies and procedures and significant judgement may be required to address newly implemented government programmes.

Companies could consider expanding disclosures on the accounting policies for government grants and the impact of grants and other assistance on the financial statements.

Property, Plant and Equipment (PPE) accounting

The COVID-19 outbreak may affect the expected useful life and residual life of PPE which requires management review. In case the expectations differ from previous estimates, then change in estimate should be accounted for in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

Borrowing costs

Capitalisation of interest on borrowings might need to be suspended in case the development of an asset has been suspended on account of COVID-19. Companies should also evaluate this area.

Disclosures in the annual reports

'Other information' that accompanies the financial statements may include additional discussion of risks associated with the outbreak if the expected impacts could be significant. Management would need to consider whether the explanation of events relevant to understanding the impact on the entity complies with regulatory requirements and responds to regulators' and users' expectations.

Disclosures should include identification of key assumptions about the impact of COVID-19 on material estimates and sources of estimation uncertainty that could result in material adjustments to the carrying amount of assets and liabilities, including sensitivity analysis.

Additionally, more extensive disclosures about company's policies and processes for managing its credit or liquidity risk exposures may become necessary.

Companies with the year end 31 December 2019

Events that occurred after the reporting date (31 December 2019) would need to be evaluated whether these events or conditions, individually or collectively, cast significant doubt on the company's ability to continue as a going concern, or in severe cases, whether the going concern assumption is still appropriate as a basis for the preparation of the company's financial statements.

Companies would need to evaluate whether the financial reporting effects of the COVID-19 outbreak should be accounted for as adjusting or non-adjusting events after the reporting period. With respect to 31 December 2019 financial statements, the financial reporting impact arising from the outbreak will likely be limited to non-adjusting events after the reporting period as the significant changes in business activities and economic conditions occurred as a result of events have occurred after the balance sheet date, such as actions taken by the government and private sector to respond to the outbreak.

When the impacts are considered as non-adjusting events, companies would need to consider whether it is appropriate to provide disclosures in their financial statements to reflect new events or changes in conditions after the reporting date, including an estimate of their financial effect if that can be determined. For instance, estimated effects on impairments of financial and non-financial assets (considering events and new information arising after the reporting date), covenant breaches, amendments or waivers in lending agreements, losses due to supply chain issues, volatility in commodities or foreign currency exchange markets, etc. after the reporting date.

Way forward

Effective communication

Companies should maintain close communications with their board of directors, auditors, legal counsel and other service providers as the circumstances progress. They should discuss with the board and the audit committee the potential financial impacts and risk assessment would help in better preparation of the financial statements.

Companies should aim to provide adequate disclosures in their year-end financial statements on current and potential impacts of COVID-19 on results of operations, liquidity and capital resources. The assessment should be based on both a qualitative and quantitative assessment on their business activities, financial situation and economic performance.

The sectors that are likely to be mostly affected by the COVID-19 outbreak are aviation, tourism, hospitality, Information Technology (IT), pharmaceuticals, automotive, building and construction and consumer goods. Additionally, banking sector would be impacted by the shutdowns in industries and this could result in rise in Non-Performing Assets (NPAs).

Potential impact on audit, an auditor's report and completion of the last quarter's results and annual financial reporting process

Companies may face challenges in helping auditors to conduct their audits as it may be difficult to provide them access to their establishments (e.g. not being able to observe management's inventory counts or to physically verify fixed assets after year-end). Also, in certain situations, companies may have challenges in obtaining access to management and others, including legal counsel, management's experts due to travel restrictions. They may not be able to provide the anticipated audit evidence e.g. there could a significant decline in response rates for bank and/or debtor confirmations. For large companies with various overseas components, there could be a significant challenge to work with component auditors and managements of the overseas components.

These challenges could lead to certain implications in the auditor's report which may include:

- Reporting of a new Key Audit Matter (KAM) in response to additional audit work necessary as a result of the outbreak
- Addition of a material uncertainty in relation to going concern paragraph, where relevant
- An emphasis of matter paragraph relating to a significant uncertainty arising from the outbreak
- A qualification or adverse opinion in respect of inadequate disclosures in the financial statements.

The above challenges could delay in completing the last quarter's results and annual financial reporting process.

Recently, the Securities and Exchange Board of India (SEBI) and the Ministry of Corporate Affairs (MCA) have decided to provide temporary relaxations in compliance requirements to companies.

As part of the relaxations, SEBI has extended the timelines for filing of financial results for the quarter and year ended 31 March 2020 up to 30 June 2020 by equity listed companies. The timeline for filing financial results by companies with listed Non-Convertible Debentures (NCDs)/Non-Convertible. Redeemable Preference Shares (NCRPS)/ Commercial Papers (CPs) for the half-year and year ended 31 March 2020 have also been extended up to 30 June 2020.

Additionally, listed companies are exempted from observing the maximum stipulated time gap between two board/audit committee meetings (i.e. 120 days) for the meetings held or proposed to be held between the period 1 December 2019 and 30 June 2020.

According to the recent MCA notification, directors can participate in meetings to discuss matters such as approval of financial statements, board's report, etc. through video-conferencing or other audio-visual means in place of mandatory physical presence up to 30 June 2020.

Given the situation, the government and SEBI may grant more relief measures. Hence, companies should continue to assess this area.

Resource center on financial reporting impacts of COVID-19

Also refer to KPMG International's **resource center** on COVID-19. The resource center includes Frequently Asked Questions (FAQs) on significant accounting and disclosure implications for companies on account of COVID-19 and highlights the actions to be taken by the management.