COVID-19: Potential impact on financial reporting

24 March 2020

First Notes on

Financial reporting

Corporate law updates

Regulatory and other information

Disclosures

Sector

All

Banking and insurance

Information, communication, entertainment

Consumer and industrial markets

Infrastructure and government

Relevant to

All

Audit committee

CFO

Others

Transition

Immediately

Within the next three months

Post three months but within six months

Post six months

Forthcoming requirement

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.

Going concern (cont.)

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. 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

Companies would need to assess the impact on revenue recognition aspects such as revision of estimates of variable consideration and also timing of revenue recognition including assessment of whether consideration is probable in case of sales to customers in COVID-19 affected states in India and regions around the world. Also, they should consider related impact on recoverability of trade receivables including estimate of expected credit losses.

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 and revenue recognition by lessor.

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.

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 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.

Way forward (cont.)

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.

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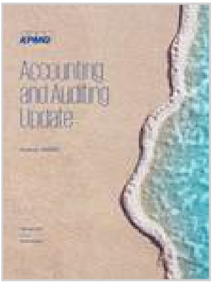
KPMG in India's IFRS institute

Visit KPMG in India's IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

Missed an issue of Accounting and Auditing Update or First Notes



Issue no. 43 – February 2020

The topics covered in this issue are:

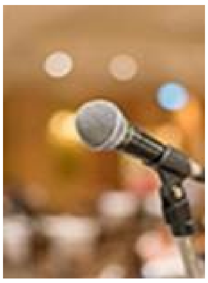
- Auto sector- Impact of slowdown on financial reporting
- SEBI reviews norms relating to related party transactions
- US GAAP- Recent emerging issues
- Regulatory updates.

The Reserve Bank of India issues regulatory guidance on Ind AS for NBFCs and ARCs

20 March 2020

Considering the impact of Ind AS on the regulatory provisions, on 13 March 2020, the Reserve Bank of India (RBI) issued a notification providing regulatory guidance on Ind AS. These guidelines aim to promote high quality and consistent implementation of Ind AS (pertaining to specific prudential aspects), and to facilitate comparison and better supervision. The RBI guidelines are applicable to Non-Banking Financial Companies (NBFCs) and Asset Reconstruction Companies (ARCs) for preparing their financial statements for financial years 2019-20 and onwards.

This issue of First Notes provides an overview of the RBI guidelines.



Voices on Reporting

KPMG in India is pleased to present Voices on Reporting (VOR) – a series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

A special session of VOR webinar was held on 26 February 2020 to discuss key implementation issues in relation to business combination standard for technology sector.

To access the presentation and audio recording, please click here.

Feedback/queries can be sent to aaupdate@kpmg.com

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