COVID-19: Corporate reporting implications

KPMG Board Leadership Centre

The rapid outbreak of the coronavirus is first and foremost a public health emergency and our thoughts remain with those impacted. As the disruption and implications for COVID-19 impacts us all, we are seeing significant challenges for businesses across the UK. There are significant corporate reporting and audit considerations from this disruption. This document looks at some of the challenges businesses face and how they might respond when preparing financial statements and interim reporting under IFRS.

Most, perhaps all, companies will be affected by the coronavirus outbreak and ensuing economic crisis. Every company should monitor the current and potential effects that the coronavirus pandemic may have on their corporate reporting based on their individual circumstances. Consider issues like:

- the extent to which the demand for the company's goods/services might be impacted and how this will impact cash flows, margins and profitability;
- the company's future funding needs and whether appropriate discussions are being held with key finance providers and creditors;
- the company's exposure to fluctuations in the value of Sterling and other currencies;
- the impact on the company's supply chain and increased costs on cash flow and profitability; and
- contractual issues such as penalties for delays in supply.

Corporate reporting

The financial reporting impacts of the outbreak will depend on facts and circumstances, including the degree to which an entity's operations are exposed to the impacts of the outbreak and the sensitivity of amounts recorded in the financial statements to the more volatile economic conditions.

It is important to understand the nature and extent of an entity's potential exposure to the impacts of the outbreak, in particular the entity's ability to continue as a going concern and the need for additional disclosures to reflect new or elevated risks and uncertainties triggered by the outbreak.

Adjusting versus non-adjusting event

With respect to financial statements for the year ended 31 December 2019, the financial reporting effects of the outbreak are generally considered to be non-adjusting events (with the exception of going concern) as the significant changes in business activities and economic conditions occurred as a result of events occurring after the reporting date of 31 December 2019, such as actions taken by the government and private sector to respond to the outbreak.

Although certain events did occur prior to 31 December 2019 (for example, the Wuhan Municipal Health Committee issued an urgent notice in respect of the virus on 30 December 2019 and cases were reported to the World Health Organization (WHO) on 31 December 2019), the WHO announcement of Coronavirus as a global health emergency was only made on 31 January 2020 i.e. after the end of the reporting period, and measures taken by many national governments followed this announcement.

Assumptions used in impairment calculations for financial and non-financial assets at the reporting date need to reflect reasonable and supportable information available as at 31 December 2019.

Professional judgement, considering the specific facts and circumstances, will be needed. In particular, caution should be exercised to avoid inappropriately using hindsight or developing valuation inputs that are not consistent with the conditions or reasonable expectations as at 31 December 2019.

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For example, outcomes that would not have been reasonably expected at 31 December 2019 should not be reflected in the recoverable amount calculations of non-financial assets under IAS 36.

When the impacts are considered to be non-adjusting events and would not affect amounts recognised as of 31 December 2019, to the extent that these non-adjusting events are material, entities would need to provide appropriate disclosures that reflect the nature of these events or changes in conditions after the reporting date, including an estimate of their financial effect if that can be determined.

For example, non-adjusting events could include 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 exchange markets etc. after 31 December 2019.

Examples of events or conditions that may be material non-adjusting subsequent events and warrant disclosure in the financial statements could include:

- Significant business interruption arising from supply chain disruption, closure of manufacturing or commercial facilities, travel restrictions and logistics disruption, unavailability of personnel etc.;
- Significant declines in sales, earnings and / or operating cash flows;
- Losses in contracted business or losses / exposures arising from counterparties asserting force-majeure;
- Debt restructuring or entering into significant commitments including new loan facilities;
- Breach of a significant loan covenant or a debt default after the reporting date;
- Abnormally large changes in equity or debt securities prices, foreign exchange rates or interest rates after the reporting date that will significantly impact the measurement of assets and liabilities in future periods; and
- Restructuring and redundancy plans.

When non-adjusting subsequent events after the reporting period are material, disclosure is required of the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made.

In contrast, for subsequent reporting periods ending after 31 December 2019, (i.e. 2020 interim reporting for calendar year-end entities, or entities with annual reporting date after 31 December 2019), the accounting impacts arising from events and conditions that occur before the reporting periods will need to be recognised, if material.

Going concern

The assessment as to whether the going concern basis is appropriate takes into account events and conditions after the end of the reporting period. As there have been significant new events and changes in conditions since 31 December 2019, for entities with a calendar year-end, it will be necessary to reflect the impacts of these events and conditions in the going concern assessment.

It will be critical to understand the impact current events and conditions have had on the entity's operations and forecast cash flows, with the key immediate issue being whether the entity still has sufficient liquidity to continue to meet its obligations as they fall due, considering also continued compliance with any conditions, e.g. covenants. Relevant considerations will include whether the entity has sufficient cash and unused credit lines/borrowing facilities to meet short-term needs, and whether further actions are needed to enable the entity to generate sufficient cash flow to meet its obligations when they fall due. Further actions that may be required could include negotiating with lenders to restructure and/or increase borrowing facilities, revising or waiving covenants, restructuring operations to reduce operating costs, deferring capital expenditures, seeking financial support from shareholders and/or accessing national and/or local government programs designed to support businesses.

The impact of current events and conditions on the going concern assessment will vary considerably from sector to sector, but it is clear that entities in highly exposed sectors, particularly travel and tourism, hospitality/entertainment/sport, retail and the oil industry, which are experiencing declining demand, falling sales and margin pressures, will be more significantly impacted than others.

Over time, the impact on sectors such as automotive may increase if consumers defer large purchases until the uncertainty recedes.

In many cases, budgets and forecasts that may have been used to support an initial going concern assessment may now be of limited relevance given the rapidly changing economic and business circumstances and may require reworking using severe but plausible downside scenarios in order to support the going concern assessment.

Events or conditions occurring after the reporting date that might be considered when making or updating the assessment of the entity's ability to continue as a going concern may include:

- *Weaker economic outlook / increased uncertainty*: Lower sales / earnings and deterioration in working capital ratios may significantly impact operating cash flows.

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- *Availability and cost of credit*: Borrowers with weaker credit ratings may find it more difficult to access bond markets, and may find banks and other lenders less willing to renew or increase borrowing facilities. Similarly, Lenders may demand new terms, such as significantly higher yields or improved collateral, particularly for entities in highly exposed sectors.

  Lenders themselves may be experiencing liquidity issues and may need central bank assistance to be able to continue to provide, or increase, financing.

  Borrowers with foreign currency denominated in debt may find debt servicing costs increase significantly due to the deprecation of their local currency

  Adverse material change clauses in loan agreements may provide lenders with an opportunity to withdraw financing
- *Decline in asset values*: Lower earnings may impact compliance with financial covenants and perceived creditworthiness. Also, proceeds will be reduced in the event of asset disposals

When events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are identified, consider potential remedial actions such as:

- refinancing or restructuring existing debt facilities (including loans, leases and other payables) and/or obtaining new sources of financing;
- renegotiating financial covenants and /or seeking waivers if there is a risk of non-compliance with covenants in loan agreements;
- protecting revenues, cutting costs and managing working capital balances to generate sufficient operating cash flows to meet obligations as they fall due;
- managing liquidity by deferring capital expenditure, dividends and other distributions, seeking financial support from shareholders, taking advantage of government assistance and making claims under business interruption insurance policies; and
- restructuring operations to respond to supply chain or other disruptions, or significant changes in demand.

If the consequences of the pandemic, individually or collectively, are so severe that the going concern basis of preparation is no longer considered appropriate, the financial statements as at 31 December 2019 would need to be prepared on a basis other than going concern.

To the extent that events and conditions are identified that cast significant doubt on an entity's ability to continue as a going concern, disclosure would be required if these events constitute material uncertainties or if the conclusion involved significant judgement (i.e. a 'close call' scenario). Given the significance and widespread impacts of COVID-19, particularly for entities in highly exposed sectors, these types of disclosures are more likely to be considered necessary than in prior reporting periods.

Other information

At the same time as addressing the risks associated with COVID-19 in the going concern scenarios modelled, companies need to be making clear disclosure of the risks that COVID-19 brings to their business model. This needs to be clearly addressed in the Strategic Report and the disclosure of principal risks and uncertainties. Steps being taken to mitigate the risks should also be disclosed.

Disclosing risks to the market can exacerbate liquidity problems and prompt creditors and shareholders to take action. Companies face a difficult challenge in meeting and satisfying their obligations to report and anticipating the potential effects. The terms of disclosures should be carefully considered.

The audit challenge

Auditors could face significant challenges conducting their audits due to:

- Barriers to obtaining the information needed to perform procedures and reach conclusions, including obtaining access to management's IT systems;
- Controls over the financial statement preparation process may have been modified or potentially are rendered ineffective due to company personnel being absent due to illness or remote working arrangements;
- Challenges in obtaining access to management and others, including legal counsel, management's or auditor's experts;
- Difficulties accessing company premises to perform procedures (e.g. not being able to observe management's inventory counts or to physically verify fixed assets after year-end);
- Audit procedures not providing the anticipated audit evidence, requiring modifications to the audit approach (e.g. a significant decline in response rates for bank and/or debtor confirmations);

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- A need to respond to risks of material misstatement arising from limitations on information and/or management having less time than usual to prepare the financial information;
- A need to perform additional audit work to respond to risks of material misstatement arising from the potential financial effects of the outbreak and the oil market disruption (e.g. additional procedures to evaluate the appropriateness of management's assessment of the entity's ability to continue as a going concern);
- Difficulties in directing and supervising the work of other team members, and impediments to completing the audit as a result of the engagement team having to work remotely and engagement team members being off work due to illness or to care for others; and
- Significant challenges to group engagement teams, in particular, in directing, supervising and reviewing the work of component auditors, and for component auditors in completing their audits and reporting to the group engagement team on a timely basis.

These challenges may cause significant delays in the completion of audits and may also impact the ability of auditors to obtain sufficient appropriate audit evidence.

Consequently, auditors may not be able to meet previously agreed deadlines, may need to make changes to their audit strategy and plan, and may need to consider the implications for their report on the financial statements. It is critical that audit committees stay abreast of these issues and work with the auditors to help ensure an effective audit.

Effective communications

Auditors are required to communicate on a timely basis with those charged with governance – usually the audit committee – with respect to:

- Significant changes in the planned scope and timing of the audit, including new significant risks and modifications to the audit strategy and plan;
- Significant difficulties encountered during the audit, including with respect to:
- Obtaining sufficient appropriate audit evidence and /or completing their audit procedures;
- Potential delays in obtaining sufficient appropriate audit evidence;
- Significant matters that were discussed or subject to correspondence with management, including disagreements; and
- Expected modifications to the auditor's report e.g. modifications as a result of a scope limitation or disagreement, emphasis of matter paragraphs in respect of significant uncertainty etc.

Communications should be timely and, in the light of rapidly developing events, will likely need to be more frequent than usual.

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