Outbreak of COVID-19: Financial Reporting Implications

The outbreak of COVID-19 has affected not just the health of people but also the health of businesses across the globe. This crisis has affected most companies either directly or indirectly belonging to sectors such as healthcare, finance, real estate, motor vehicles, pharmaceuticals, etc. The economic uncertainty has caused a significant impact on financial reporting due to increased market risks including an overall reduction in demand and production shutdown post mid – March 2020.

For the preparation of interim financial statements for the quarter ending June 2020 and onwards, and financial statements as of December 2020, businesses need to evaluate the impact of COVID-19 on Accounting and Financial reporting, depending upon the facts and circumstances as well as the extent of exposure.

Key impacts on Financial Reporting A glimpse into-

1. Going Concern
2. Inventories Measurement
3. Income Taxes
4. Provisions
5. Property, Plant, and Equipment (PPE) and Impairment thereof
6. Revenue
7. Leases – Modifications/Terminations
8. Fair Value Assessment
9. Financial Instruments – Impairment Losses
10. Government Grants
11. Post Balance Sheet Events

1. Going Concern

The entity's management needs to evaluate the impact of COVID-19 in the light of their ability to continue as a 'Going Concern' as required by IAS 1 – Presentation of Financial Statements. This assessment should be done based on the current conditions and information post the Balance sheet date by applying IAS 10 - Events After The Reporting Period. The assessment of the impact on the entity's operations and forecasted cash flows and the determination of liquidity to meet its obligations relate to at least the first 12 months after the balance sheet date or post the date of signing the financial statements. However, this timeframe might need an extension. The events occurring after the balance sheet date may indicate that the entity ceases to be a 'Going Concern'; thus, they need to assess if they can use the fundamental accounting assumption of 'Going Concern' to prepare its financial statements.

Disclosure of material uncertainties that cast significant doubt on the company's ability to operate under the 'Going Concern' basis needs to be considered. Given the considerable uncertainty, disclosures should include the significant assumptions and judgments applied to making 'Going Concern' assessments. In such cases, the management may also draw users' attention to these notes in the financial statements.

2. Inventories Measurement

In the current scenario, entities need to assess if there is a decline in their future estimated selling prices. Accordingly, the carrying amount of the inventories need to be written down to the net realizable value as on the balance sheet date. Also, in cases where the inventories of finished goods are expected to be sold below cost, materials and other supplies held for use in production (as well as any work-in-progress) may also require a write-down.

Entities also need to evaluate the impact of various lockdown measures on fixed overhead absorption rate.

3. Income Taxes

Entities with Deferred Tax Assets (DTAs) should consider reassessing their forecasted profits and in turn, the recoverability of DTAs and the possibility of generating DTAs due to additional deductible temporary differences resulting from various factors (e.g. asset impairment) under IAS 12 - Income Taxes. A change in future profits may also reduce the number of Deferred Tax Liabilities (DTLs). The management should disclose any significant judgments and estimates made in assessing the recoverability of DTAs in line with IAS 1.

4. Provisions

Due to COVID-19 there is a need to exercise judgment in making provisions for losses and claims as demonstrated below:

Onerous contracts

Certain contracts might become onerous wherein the cost of fulfilling the obligations exceeds the economic benefits due to reduced production, increase in the costs/unavailability of labor/raw material, etc. Delays in completion of the contract may also result in penalties. Such contracts need to be accounted as per IAS 37 - Provisions, Contingent Liabilities, and Contingent Assets. The management needs to disclose whether the assessment of executory contracts is being onerous due to the impact of COVID-19. If failed to assess that some of the executory contracts have turned onerous due to inadequate information, then the same needs to be disclosed.

Insurance claims

If the entities have insurance policies covering losses due to events such as COVID-19, the entity must recognize the claims only if its recovery is virtually certain as per IAS 37.

5. Property, Plant, and Equipment (PPE) and Impairment thereof

Many entities might face a problem of underutilization/non-utilization of PPE due to low demand for their products and services, closure of the production units owing to the lockdown, thereby affecting the expected useful life and the residual value of these assets. Hence, the management needs to review the estimate of the useful life and residual value and changes, if any, need to be accounted for in accordance with IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors.

Impairment may be triggered due to the changed circumstances requiring an impairment test as per IAS 36 – Impairment of Assets. Many entities might face challenges in estimating future cash flows due to economic uncertainties. Disclosures need to be provided as per IAS 36 regarding risks associated with assumptions and sensitivities used for forecasting future profits in the estimated recovery amount.

In respect of goodwill, there might be significant changes with an adverse effect in operations of a cash-generating unit to which goodwill is allocated, and thus, testing the impairment of goodwill needs special attention as of 31 December 2020.

6. Revenue

There would generally be cases for decrease or increase in sales returns, higher price discounts, etc. Due to COVID-19, these factors should be considered while measuring the variable consideration as per IFRS 15 – Revenue from Contracts with Customers. Since IFRS 15 requires disclosure of information that allows users to understand the nature, amount, timing, and uncertainty of cash flows arising from revenue, entities need to consider the disclosure of the impact of COVID-19 on the income.

7. Leases

Modifications to the contract/arrangement

While accounting for leases in the financial statements, the impact of the modifications in the lease arrangements due to changes in terms of lease arrangements need to be considered, wherein the lessor might give concessions for rent payment/rent-free periods, etc. Anticipations in the terms should not be accounted for.

An amendment to IFRS 16 - IASB has been issued in May, 2020, which inserted a practical expedient for lessees. It grants the lessee an option to not apply for the lease modification provisions where lease concessions are a direct result of the COVID-19 pandemic subject to the issued criteria.

For further information on the article, visit https://bit.ly/3isVCHu

Variable lease payments

Variable lease payments to be accounted for as per IFRS 16 - Leases might get impacted, where the payments are linked to the revenues from the use of the underlying assets, due to reduced financial activity of the lessee.

Discount rate

Risks associated with the discount rate to determine the present value of the new lease liabilities need to be considered.

Reassessment

Entities need to assess whether any lease arrangement has become onerous due to the COVID-19 situation as per IAS 37.

8. Fair Value Measurement

Fair values of assets/liabilities as prescribed by certain standards such as IFRS 9 – Financial Instruments and IAS 16 – Property Plant and Equipment (PPE) are to be determined as per IFRS 13 – Fair Value Measurement. As per IFRS 13, fair values' determination depends on the observable market price or application of valuation techniques. Due to COVID-19, there has been a substantial decline in the market prices of financial instruments as well as a reduction in the level of activity in the current capital and financial market. This has led to a change in the assumptions used to measure fair values such as discount rates, credit-spread/ counterparty credit risks, etc.

Sensitivity disclosures along with disclosures in respect of the key assumptions and judgments made by the management need to be provided under the IAS 1 – Presentation of Financial Statements and IFRS 13.

9. Financial Instruments – Impairment Losses

Due to the significant decline in economic activity across the globe, estimation of Expected Credit Losses (ECL) would be a challenging task for the management, which requires incorporating forward-looking information relating to the impact of COVID-19. The relevant disclosures such as methods, assumptions, and data used in estimating ECL are necessary as per IFRS 7 – Financial Instruments Disclosures. If the entity is unable to assess the impact of COVID-19 while evaluating the impairment due to inadequate information, the same needs to be appropriately disclosed.

10. Government Grants

The management needs to monitor government legislations to assess whether the assistance provided amid the COVID-19 outbreak meets the definition of government grants. Entities need to consider the disclosures on accounting policies for government grants and their impact and other assistance on the entity's financials.

Grants in respect of lease agreements

Any form of compensation provided/declared to the lessor for offering a concession to the lessee, requires an assessment to conclude whether the assistance is as a lease modification under IFRS 16 - Leases or as under IAS 20 – Accounting for Government Grants and Disclosure of Government Assistance.

11. Post Balance Sheet Events

The uncertainty and challenges posed by the COVID-19 situation require the management to carefully evaluate the effects of subsequent events and latest developments occurring post the balance sheet date and before the date of Auditor's report. This will help with more information about the circumstances during the reporting date. The effect of such events on the financials should be considered in accordance with IAS 10 – Events After The Reporting Period.

The entity should provide robust disclosures about the pandemic's potential impact on the entity's operations, liquidity, and capital resources, and the measures taken to handle the situation. They need to ensure that the Senior Management is updated about the developments so that the effect is well captured in the company's financial statements.

About Nexdigm (SKP)

Nexdigm (SKP) is a multidisciplinary group that helps global organizations meet the needs of a dynamic business environment. Our focus on problem-solving, supported by our multifunctional expertise enables us to provide customized solutions for our clients.

Our cross-functional teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, we have built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

We provide an array of solutions encompassing Consulting, Business Services, and Professional Services. Our solutions help businesses navigate challenges across all stages of their life-cycle. Through our direct operations in USA, India, and UAE, we serve a diverse range of clients, spanning multinationals, listed companies, privately owned companies, and family-owned businesses from over 50 countries.

Our team provides you with solutions for tomorrow; we help you *Think Next.*

@nexdigm

*@nexdigm_*

@NexdigmThinkNext

@Nexdigm

Subscribe to our Insights

USA Canada India UAE Japan Hong Kong

Reach out to us ***ThinkNext@nexdigm.com***

www.nexdigm.com
www.skpgroup.com