Outbreak of COVID-19 – Financial Reporting Implications

A rapid and an alarming outbreak of the Novel Coronavirus (COVID-19) has affected the health of people around the globe. This crisis has affected most of the companies in India 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 overall reduction in demand and production shutdown post mid – March 2020.

For the preparation of financial statements as at 31 March 2020 as well as interim financial statements for the quarter ending June 2020, companies need to evaluate the impact of COVID-19 on Accounting and Financial reporting as well, depending upon the facts and circumstances and the extent of exposure to the crisis.

Key impacts on Financial Reporting:

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. Post Balance Sheet Events
11. Government Grants
12. Impact on Auditors' Report

Going Concern

The entity's management needs to evaluate the impact of COVID-19 in the light of the entity's ability to continue as a going concern as required by Ind AS 1 – Presentation of Financial Statements and AS 1 – Disclosure of Accounting policies. This assessment should be done basis the current conditions as well as information post the Balance sheet date by applying Ind AS 10 - Events After The Reporting Period (to entities with Ind AS applicability) and AS 4 – Contingencies and Events Occurring After the Balance Sheet Date (revised 2016) (to entities with Non-Ind AS applicability). The assessment of impact on the entity's operations and forecasted cash flows as well as the determination of liquidity to meet its obligations, relates to a period of at least the first twelve months after the balance sheet date, or post the date of signing the financial statements. However, this timeframe might need to be extended. Events occurring after the balance sheet date may indicate that the entity ceases to be a going concern, and hence the entity needs to assess whether it is appropriate to use the fundamental accounting assumption of going concern for the preparation of 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 significant uncertainty, disclosures should include the significant assumptions and judgments applied in making going concern assessments. In such cases auditor may, also draw attention of users to these notes in the financial statements.

Inventories Measurement

In the current scenario, the entities need to assess whether there is a decline in their future estimated selling prices and accordingly, the carrying amount of the inventories need to be written down to the net realizable value as on the Balance sheet date. Also, where the finished goods inventories 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 lockdown measures on fixed overhead absorption rate.

Income Taxes

Entities with Deferred Tax Assets (DTAs) should consider reassessing forecasted profits and in turn the recoverability of DTAs as well as the possibility of creation of DTAs due to additional deductible temporary differences resulting from various factors (e.g., asset impairment) in accordance with AS – 22 / Ind AS 12 - Income Taxes. Change in future profits may also reduce the number of deferred tax liabilities. Management should disclose any significant judgments and estimates made in assessing the recoverability of deferred tax assets in accordance with Ind AS 1.

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 exceed the economic benefits due to conditions such as 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 Ind AS 37 / AS 29 - Provisions, Contingent Liabilities, and Contingent Assets. Management needs to disclose whether the assessment of executory contracts being onerous is made due to the impact of COVID-19. In case the management is unable to assess whether some of the executory contracts have become onerous due to inadequate information, the same needs to be disclosed.
- **Insurance claims:** Where 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 Ind AS 37 / AS 29.

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

Many entities might face a problem of under utilization/ non utilization of PPE due to low demand for their products/ services/closure of the production units owing to the lockdown. It may affect the expected useful life and residual value of the assets. Hence, the management needs to review the estimate of the useful life and residual value and changes, if any in the estimates, need to be accounted for in accordance with Ind AS 8 - Accounting Policies, Changes in Accounting Estimates and Errors and AS 5 – Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Impairment may be triggered due to the changed circumstances requiring impairment test as per Ind AS 36/ AS 28 – Impairment of Assets. Many entities might face challenges in estimating future cash flows due to economic uncertainties. Disclosures need to be provided as per Ind AS 36/AS 28 regarding risk associated with assumptions and sensitivities used for forecasting future profits in estimating 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 of Impairment of goodwill needs special attention as of 31st March 2020.

Revenue

There would generally be cases for decrease in the sales, increase in sales returns, higher price discounts, etc. Due to COVID-19, these factors should be considered while measuring the variable consideration as per Ind AS 115 – Revenue from Contracts with Customers. Since Ind AS 115 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 revenue. Entities to whom AS – 9 – Revenue Recognition is applicable, required to disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainty.

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 the 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.
- ***Variable lease payments:*** Variable lease payments to be accounted for as per Ind AS 116 - 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 taken into consideration.
- ***Reassessment:*** Entities need to assess whether any lease arrangement has become onerous due to the COVID-19 situation as per Ind AS 37 / AS 29.

Fair Value Measurement

Fair values of assets/liabilities as prescribed by certain standards such as Ind AS 109 – Financial Instruments and Ind AS 16 – Property Plant and Equipment are required to be determined as per Ind AS 113 – Fair Value Measurement. As per Ind AS 113, the determination of fair values depend on 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 leading to a change in the assumptions used to measure the 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 Ind AS 1 – Presentation of Financial Statements and Ind AS 113.

Financial Instruments – Impairment Losses

Due to the significant decline in the economic activity across the globe, estimation of Expected Credit Losses (ECL) would be a challenging task for the management, which requires the incorporation of forward-looking information relating to the impact of COVID-19. Relevant disclosures such as methods, assumptions, and data used in estimating ECL are required as per Ind AS 107 – Financial Instruments Disclosures. If the entity is unable to assess the impact of COVID-19 in estimating the impairment loss due to inadequate information, the same needs to be disclosed appropriately.

Government Grants

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

Grants in respect of lease agreements: Where any compensation is provided/declared to the lessor for providing concession to the lessee, assessment is needed to conclude whether the assistance is to be accounted for as a lease modification as per Ind AS 116 / AS – 19 - Leases or to be accounted as per Ind AS 20 / AS 12 – Government Grants.

Post Balance Sheet Events

The uncertainty and challenges posed by the COVID-19 situation require the management to carefully evaluate the impact of the subsequent events and latest developments occurring post the balance sheet date and before the date of Auditor’s report, which provides more information about the circumstances that existed during the reporting date. The effect of such events on the financials should be considered in accordance with Ind AS 10 – Events After The Reporting Period and as per AS – 4 Contingencies and Events Occurring After The Balance Sheet Date.

Impact on Auditors' Report

Many challenges would be faced by the Auditors in obtaining appropriate and reliable evidences e.g. difficulty in attending the inventory count conducted by the management/difficulty in conducting physical verification of assets post the balance sheet date. Also, on evaluation of the impact of the disruption on entity operations, the Auditor’s report may include the following depending upon the requirement:

- Emphasis of Matter (EOM) paragraph relating to the uncertainty arising due to the COVID situation
- Key Audit Matter (KAM) due to additional audit work needed to be carried out by the auditor
- Inclusion of Material uncertainty related to going concern assessment paragraph

The entity should focus on providing robust disclosures about the potential impact of the pandemic on the entity's operations, liquidity, and capital resources and the steps taken by the management to cope with the situation. One needs to ensure that the Auditors and the Senior Management are well updated about the developments/changes 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.

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