COVID-19: Financial reporting considerations

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Overview

The novel coronavirus (COVID-19) pandemic is spreading around the globe rapidly. The virus has taken its toll on not just human life, but businesses and financial markets too, the extent of which is currently indeterminate.

While the outbreak has had an impact on almost all entities either directly or indirectly, some of the worst hit sectors are aviation, hospitality and retail with more and more sectors coming under its radar with widespread lockdowns being enforced across the world. The aviation industry is facing a massive disruption with travel restrictions imposed by most jurisdictions. The hospitality sector has been impacted with low occupancy in business and holiday destinations having to close down entirely. Other affected sectors are automobiles, apparel, consumer durables, pharmaceuticals, leather goods, electronics and others where the supply chain is dependent on countries worst hit by COVID-19. Financial services have also been affected with the inability of borrowers to keep up with repayment schedules.

This publication highlights some of the key financial reporting implications that businesses need to consider in preparation of their financial statements in the wake of COVID-19 crisis.

Revenue recognition

As revenues decline, capacities remain under-utilised and in some cases complete shutdown of businesses, entities will need to reassess the impact on revenue recognition. In some cases, force majeure clauses might be invoked, the impact of which will depend on the related terms and conditions in the contract. Specific impact is likely to be in terms of:

- **Variable considerations (e.g.: discounts, refunds, price concessions, performance bonuses and penalties):** Adjustments to transaction price may be necessitated owing to the facts and circumstances, as per the principles of Ind AS 115, Revenue from Contracts with customers (Ind AS 115), as these need to be reassessed on each reporting date throughout the contract period and can only be recognised to the extent it is probable that a significant reversal will not occur when the uncertainty is resolved. In line with the requirement of the standard to disclose the nature, amount, timing and uncertainty of revenue and cash flows affected by economic factors, affected companies will need to provide sufficient information for the users to understand the impact of the pandemic on the revenue estimates made by them.
- **Existence of a contract:** Where goods and services have been or are being rendered to customers who are either based in regions impacted by COVID-19 or significantly impacted by it, companies will need to assess whether collection is probable while evaluating new contracts. In the absence of such probability, companies may not be able to recognise revenue because such contracts are not likely to be treated as a contract that meets the recognition criteria under the Ind AS 115.

Taxes

As the economic outlook deteriorates, recoverability of any recognised deferred tax assets will need to be carefully reviewed. Estimates of future growth, market prices of goods/services, timing of cash flows, and other assumptions underlying the assessment of availability of future taxable profits are likely to undergo a change. Considering the unprecedented circumstances, the future projections may be subject to multiple uncertainties. Further, for companies with global presence, considering the likelihood of change in earnings of foreign subsidiaries, management may also have to reconsider some of their tax strategies. In some jurisdictions, companies may also be granted tax waivers or deferrals, which need careful assessment of eligibility and the consequential impact on tax provisioning.

Insurance claim for loss of profits/government grants

Insurance policies for loss of profits/business closure generally cover losses of gross profit or reimbursement of certain expenses for periods during which a company is unable to conduct its usual operations. As businesses suffer due to COVID-19, it is likely that there will be increased insurance claims. Admissibility of these claims would depend on whether policy includes claims towards losses incurred on account of communicable diseases or the nature of expenses that can be claimed, etc. Insurance claims filed by companies are only contingent assets as per Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets (Ind AS 37), until the claim is accepted by the insurer. They can be recognised as income in the financial statements only on such acceptance. Governments in various jurisdictions may also extend specific support in the form of grants to industries that are adversely impacted by the virus. In such cases, it is essential to distinguish between government assistance and government grants and ensure that grants are recognised only when the recognition criteria as per Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance (Ind AS 20), are met.

Impairment

Disruption to the supply chain, reduced workforce availability, restrictions on operations, decrease in market prices and reduced demand can impact an entity's estimate of future cash flow projections, indicating reduction in recoverable amount of a cash generating unit. Companies may also see an increase in cost of production if they have to replace existing suppliers or move their operations to another region. Market capitalisation of companies could also see a sharp decline owing to volatile markets.

- **Impairment indicators:** A short-term disruption may not indicate an impact on recoverability of reporting unit. However, if the company's operations are significantly impacted by the pandemic on account of multiple factors discussed above and where it is assessed that the COVID-19 pandemic is an event that is likely to have an impact on the recoverable value of reporting unit, an impairment assessment should be undertaken in accordance with the principles of Ind AS 36, Impairment of Assets (Ind AS 36).
- **Changes in assumptions:** Previous assumptions used for cash flow models may not hold good in view of the rapidly changing circumstances. Cash flow models for impairment testing may need to consider a broad spectrum of possible scenarios. Where fair values are used to determine recoverable amounts, the fair value assessments should be updated to reflect the current economic scenario. Annual tests of goodwill and intangibles with indefinite useful life, in particular, carried out in earlier periods, may need to be updated for year-end reporting. Also, it is unlikely that any impairment tests carried out before the outbreak of the pandemic will hold good for the year-end impairment testing.

Financial assets

Investments in equity and debt (i.e., loan) carried at fair value under Ind AS 109, Financial Instruments (Ind AS 109), held in entities that are either significantly impacted or are domiciled in affected areas, are likely to suffer significant volatility. Moreover, the gravity of COVID-19 has caused volatility in the global and domestic markets rendering its impact on fair value of all other investments as well. If an asset is measured at fair value on the basis of quoted prices in an active market, the relevant prices are the ones on the balance sheet date. Subsequent movements in these quoted prices after the balance sheet date are non-adjusting events.

For trade receivables and other financial assets carried at amortised cost under Ind AS 109, it may be a challenge to make reasonable and supportable forecasts of future economic conditions relating to expected credit losses in the current circumstances. Every company should consider whether credit risk has been significantly increased or the loss as a result of default has increased due to a decrease in the fair value of a non-financial asset pledged as collateral. The standard requires an entity to use 'reasonable and supportable information that is available without undue cost or effort' to determine whether credit risk has increased significantly. While this typically includes forward-looking information as well as historical data such as past due status, historical data may not have much of a bearing in case of debtors who have been severely impacted by COVID-19.

Hedge accounting

Hedge effectiveness assessment is required to be performed at the inception and on an ongoing basis at each reporting date or in case of a significant change in circumstances, whichever occurs first. The current volatility in markets may result in an entity requiring to either rebalance the hedge, where applicable, or discontinuing hedge accounting if the hedges are no longer found to be effective. Also, if it is unlikely that a hedged forecast transaction (inventory purchases or sales) may not occur, hedge accounting will cease prospectively.

Debt restructuring

As a result of disruptions in the business, entities may encounter higher operating costs, cash flow challenges or revenue losses. All or any of these factors could result in changes to the financial ratios and have an adverse impact on compliance with the debt covenants. An even severe case could be difficulty or inability to meet scheduled payments of interest and principal which, in certain cases, may even lead to lenders initiating insolvency proceedings.

Some or all of the above situations may force the entity to seek changes in the terms of existing debt agreements or obtain waivers if they no longer satisfy debt covenants. Any significant modification or debt extinguishment will also need to be accounted for in accordance with the relevant requirements under Ind AS 109.

Inventory valuation

As mentioned earlier, certain companies may be experiencing supply chain disruptions. Real estate companies with inventories of under construction properties could be impacted by a fall in property prices. Seasonal inventories and perishable products might be exposed to the risk of loss due to damage, contamination, physical deterioration, obsolescence, changes in price levels or other causes. Companies would need to assess, if as on the balance sheet date, an adjustment is required to the carrying value of their inventory to bring them to their net realisable value in accordance with the principles of Ind AS 2, Inventories. Estimating net realisable value in such volatile market conditions may also be a challenge, on account of the uncertainties presented by the pandemic. Further, the current situation can also have an impact on the overhead allocations. Low or nil capacity utilisation, could lead to certain overheads being classified as abnormal costs to be written off in the Statement of Profit and Loss rather than being allocated as overheads.

Contingent liabilities

Companies may anticipate losses on account of reduction in demand, supply chain disruptions or losses due to an overall decline in economic output. However, future operating losses on existing contracts do not meet the definition of a liability unless they fall in the category of onerous contracts, and hence, should not be provided for as per Ind AS 37.

Events after the balance sheet date

Ind AS 10, Events after the Reporting Period (Ind AS 10), requires an entity to evaluate information available after the balance sheet date to determine if such information constitutes an adjusting event, which would require an adjustment to the financial statements, or a non-adjusting event, which would only require disclosure. This disclosure should include the nature of the event and an estimate of its financial effect. If it is not possible to make an estimate of an event's financial effect, an entity must disclose that fact. In our view, entities should ensure that this disclosure is clear, transparent and specific to the circumstances of the entity; broad statements regarding the general economic environment will not provide useful information to users of the financial statements.

- **Financial statements as at 31 December 2019:** In our view, the development and spread of this virus happened in 2020 and does not provide evidence of a condition that existed at 31 December 2019, and therefore, is a non-adjusting event. At 31 December 2019, there were few reported cases and little confirmed evidence of its spread amongst humans. However, even though the event is not an adjusting event in accordance with Ind AS 10, the entity is required to disclose entity-specific information on the nature of the event after the reporting period and an estimate of its financial effect, where material, in its financial statements.
- **Financial statements as at 31 March 2020:** All information that becomes available before the financial statements are issued or available to be issued should be considered in the evaluation of the conditions on which financial statement estimates are based, because these events typically represent the result of conditions that existed before the balance sheet date. Since the conditions will exist as at 31 March 2020, the financial statements as at that date should be adjusted for any changes in estimates resulting from COVID-19 pandemic, to the extent they are determinable.

Going concern

There could be significant impact on the evaluation of appropriateness of the going concern assumptions for businesses affected by COVID-19. For affected companies, management should assess potential implications of the situations such as closure of manufacturing facilities, suboptimal use of capacities due to workforce shortages, existence of significant supplier and/or customer bases in the impacted regions, Where the company has any of its components located in regions largely affected by COVID-19 such as China, Italy, etc., management should evaluate the impact of going concern situation of the component.

Ind AS 10 - Events after the Reporting Period requires the management to evaluate an entity's ability to continue as a going concern within one year after the date of financial statements. Accordingly, companies may need to update their cash flow projections for changes in assumptions and estimates. Disclosures in the notes to the financial statements are required if management concludes that substantial doubt exists or its plans to address that substantial doubt.

Disclosures

As seen from the above, COVID-19 has a considerable impact on financial statements of entities, irrespective of whether they are impacted directly or indirectly. While some entities may be severely impacted, it is unlikely for any entity to remain unscathed by it. Apart from specific disclosure requirements under respective standards, Ind AS 1 requires disclosure of sources of estimation uncertainty. COVID-19 will perhaps go down as one of the most unprecedented high-impact events that resulted in multiple uncertainties. Affected entities will need to disclose assumptions that they have made regarding future. Further, determining whether events are adjusting, or non-adjusting is a potential area that involves significant judgement; hence, a disclosure should be made under Ind AS 1 in this regard. Disclosures will also need to be made with respect to impairment tests carried out for non-financial assets including underlying assumptions. Extensive disclosures may be required under Ind AS 107, Financial Instruments: Disclosures (Ind AS 107), about changes in assumptions and estimates on account of COVID-19, including impact on the financial risks.

Conclusion

Regulators have been proactive and have announced certain relaxations in various compliance requirements. For listed entities, the Securities and Exchange Board of India (SEBI) has issued a circular on 19 March 2020 to grant temporary relaxations from compliance with certain provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 to the listed companies in relation to their quarterly/annual filings for the quarter/financial year ending on 31 March 2020. For corporate entities, the Ministry of Corporate Affairs has relaxed the rules with respect to the meeting of the Board and dispensed with the necessity of holding physical meetings on matters relating to approval of financial statements, board report, restructuring, etc. up to 30 June 2020, and is in the process of examining any other relaxations under the Companies Act, 2013, which may be necessitated in the current scenario.

The process of annual audits is also likely to pose its own challenges this year with certain procedures being undertaken by auditors remotely or certain procedures such as physical verification of inventory being rendered practically impossible to be undertaken. Corporates and auditors will need to ensure that they are in constant communication to deal with this unprecedented situation and also keep abreast of regulatory updates and guidance that may be issued from time to time.

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