IMPACT OF COVID-19 ON FINANCIAL REPORTING

INTRODUCTION

The adverse effects of COVID has been spreading its roots in India and abroad at an exponential pace. The world – wide lock downs have limited the international and domestic movement of people causing businesses to come to a standstill. The corporates are required to gear up to face the implications of Covid-19 which may arise in the period to come.

The potential impact of the outbreak is unpredictable and may result in material uncertainties which cast significant doubt on an entity's ability to operate as a going concern. Thus, it becomes essential to understand and estimate the effects of Covid-19 on businesses. The outbreak of COVID – 19 is bound to cause distress to certain sectors like travel, hospitality etc. more than others. Similarly, survival tactics used by different businesses due to limited liquidity are critical and may be the key differentiating factors.

The impact on businesses may be changing at a rapid and unprecedented pace as India has witnessed Lockdown 1 and its extension upto 3 times in Red zones requiring scaling down operations. On the other hand, Project Restart may require scaling up of businesses with limited notice for resumption of activities quickly.

In these circumstances, disclosure requirements set by GAAP may undergo changes and may require more extensive disclosures for better understanding the impact of Covid-19 on the financial statements. Through this publication, we aim to highlight relevant financial reporting considerations applicable to various companies to whom the Accounting Standards (AS) and Indian Accounting Standards (IndAS) apply. The Guidance Note was issued by the ICAI in March 2020. The Accounting Standards are applicable to all entities which are required to prepare financial statements with attention on financial statement for the year 2019 – 20.

GOING CONCERN ASSESSMENT (IndAS 1 read with IndAS 10 and AS 1 read with AS 4)

- Management should re-assess the applicability of the going concern assumption
- All information about the future for at least but not limited to 12 months from the end of reporting period should be considered
- The impact of Covid-19 after the reporting date should be deliberated upon, whether management intends to:
  - ✓ liquidate the entity or
  - ✓ cease the trading or
  - ✓ has no realistic alternative but to do so

AS 1 along with AS 4 requires events occurring after the balance sheet date may typically provide additional evidence that the enterprise ceases to be a going concern.

IMPAIRMENT OF NON-FINANCIAL ASSETS (NFA) (AS 28 and IndAS 36)

- Requirement to assess whether any NFA needs to be impaired at the end of each reporting period
- Management may consider impairment testing due to:
  - ✓ Temporary ceasing of operations
  - ✓ Immediate decline in demand or prices resulting in lowering of revenues and profitability
  - ✓ overall reduced economic activity
- Intangible assets require an annual impairment testing using recoverable amount approach (Higher of fair value less cost of disposal and value in use)
- Additional focus on Cash Generating Unit (CGU) to which Goodwill is allocated which may have been adversely impacted while testing for impairment of Goodwill

CONSOLIDATED FINANCIAL STATEMENTS (CFS) (AS 21 and IndAS 110)

- IndAS 110 allows difference between date of reporting between parent and subsidiaries by not more than 3 months
- AS 21 allows a difference of up to 6 months

BORROWING COST (IndAS 23 and AS 16)

- Capitalisation of interest to be suspended for the period during which active development of a Qualifying Asset is suspended

Impact of Covid-19 on Financial Reporting

INTERIM FINANCIAL REPORTING (AS 25 and IndAS 34)

- The recognition and measurement criteria as applicable to annual financial statements are equally applicable to interim financials
- Disclosures to be entity specific and be made after considering the likely financial impact of Covid-19 and the measures being taken to control it
- Disclosures to be made in Management Discussion and Analysis (MD&A) section about effect on Coronavirus on overall risks to the business(es) in which the entity is engaged

PROPERTY, PLANT AND EQUIPMENT (PPE) (AS 10 and IndAS 16)

- Annual revision of useful and residual life of PPE required as per standards
- Depreciation to be charged on PPE even if they remain under/ non – utilised
- Likely impact of COVID outbreak to be considered on PPE
- Need to incorporate changes in accounting estimates related to residual life and residual value

LEASES (AS 19 and IndAS 116)

- Changes in the terms of lease arrangements (excluding anticipated revision), if any, may be considered for application of accounting principles
- Contracted business activities may impact variable lease payments linked to revenues from the use of underlying asset
- Any concession given by the Government should be considered whether to be accounted as per IndAS 116 or IndAS 20, as may be applicable
- Risk associated with COVID-19 to be incorporated in the discount rate used to determine present value of minimum lease payments
- Onerous contracts should be identified and appropriate provisions to be made

INVENTORY MEASUREMENT (AS 2 and IndAS 2)

- Inventory to be valued at lower of Cost or Net Realisable Value (NRV)
- The management may consider carrying value of inventories item by item basis on NRV due to:
  - ✓ limited movement in inventory
  - ✓ decline in the selling price
  - ✓ obsolescence due to lower than expected sales

Due to adverse impact on the utilization of the production capacity, unallocated fixed production overheads should be recognized in the period in which they are incurred.

REVENUE (AS 9 and IndAS 115)

- As per IndAS 115, following factors need to be considered in estimating amount of revenue to be recognized (measurement of variable consideration):
  - ✓ sales returns
  - ✓ volume discounts
  - ✓ Higher price discounts, etc.
- Above to be disclosed along with information to understand the nature, amount, timing, and uncertainty of revenue recognition
- As per AS 9, entity may postpone revenue recognition due to significant uncertainty of collection in view of Covid-19, until resolution of significant uncertainties and disclosure of the existing circumstances

INCOME TAXES (AS 22 and IndAS 12)

- Entities with Deferred Tax Assets (DTA) should reassess the forecasted profits and the recoverability of DTA considering the additional uncertainty arising from Covid-19 and steps to control it
- Management should also consider whether the impact of the Covid-19 affects its plans to distribute profits from subsidiaries and the resultant impact on Deferred Tax Liabilities (DTL) of undistributed profits
- Disclosure of judgements and estimates made in assessments of DTA is required

Impact of Covid-19 on Financial Reporting

FINANCIAL INSTRUMENTS (AS 4, AS 13 and IndAS 109)

- In case of financial assets as per AS 4, entities shall be guided by the requirement of adjusting or non adjusting events and contingencies provision
- In respect of financial assets as per AS 13, consider the provision for decline in value of investment, which is other than temporary
- The widespread contraction in economic activity is likely to impact quantification of Expected Credit Loss (ECL) and classification of financial instrument into 3 buckets for recognition i.e. :
  - ✓ no significant increase in credit risk,
  - ✓ significant increase in credit risk
  - ✓ credit impaired

Also, management needs to consider the impact on measurement of impairment losses in following manner:

1. Probability of default –

Likelihood of default by the borrower may have increased significantly due to reduced economic activity

2. Loss given default –

Loss itself in the event of default - value of collateral and business cash flows adversely affecting the expected amount of loss;

3. Exposure at default –

Exposure to undrawn limits and commitments if utilized fully due to substantial business dislocation

FAIR VALUE MEASUREMENT (IndAS 113)

- IndAS 113 states certain fundamental principles in respect of fair value, its definition and the determination of the same
- Based on observable market price following levels are used as measurement criteria:
  - ✓ Level 1 - Quoted price in active market;
  - ✓ Level 2 and Level 3 - application of valuation techniques.
- Current environment may suggest significant volatility or indications of significant decline in market prices or volume of activity

PROVISIONS, CONTINGENT ASSETS / LIABILITIES (AS 29 and IndAS 37)

- Assessment of contract(s) if any of them have become onerous on account of:
  - ✓ imposition of penalty due to delay in supply of goods
  - ✓ increase in cost of material, labour, etc.
- Assets dedicated for contract to be tested for impairment before a liability for onerous contract is recognised
- Losses from imposition of penalty due to delay in supply of goods to be considered along with IndAS 115
- **Restructuring cost** – provision to be created only if detailed formal plan for restructuring is being implemented
- **Insurance claims** – Claims for loss of profit can be recognized only if recovery is virtually certain
- Prudent judgement required for making provisions for losses and claims
- Provisions for future operating costs or future business recovery costs are not permitted

ADDITIONAL CONSIDERATIONS - IndAS

1. Breach of loan covenants:

Re-classification of non – current liabilities into current liabilities is not required if the lender has agreed not to demand immediate payment due to breach, after reporting date and before approval of financials

2. Source of estimation uncertainty:

- Requirement to disclose in the financial statements any assumptions and major sources of estimation of uncertainty (having a significant risk of resulting in material adjustment) at the end of reporting period
- Uncertainties include any likely future scenarios created which may affect estimates as on reporting date

3. Comparative information:

- IndAS 1 requires minimum comparative information to ease comparison of financial statements over period of time
- Due to Covid-19, financials may not remain comparable, hence management should make adequate explanatory notes and disclosures regarding financial position, performance and cash flows