FINANCIAL REPORTING AND AUDITING CONSIDERATIONS ON ACCOUNT OF COVID-19

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Most countries, businesses and companies are expected to be impacted by the Covid-19 pandemic and the increased economic uncertainty may have major financial reporting consequences. Supply-chains,distribution-chains, cash-flows, demand, price variations, facility access, workforce availability, debt obligations, contract cancellations, are experiencing turbulence. Such a holistic and cumulative impact on different spheres of business operations carries a definite, and acute consequence on the financial reporting by the entity.

The role of preparers of financial statements, audit committees, auditors and regulators become critical in this situation. Distilling the impact through the requirements of existing accounting and auditing requirements frameworks and communicating it effectively will enable financial markets to base their decisions on such robust and dependable inputs.

Auditors' role will require special attention in relation to appropriate treatment of the financial impacts and disclosures thereof. The Institute of Chartered Accountants of India has issued an *'Accounting & Auditing Advisory on Impact of Coronavirus on Financial Reporting and the Auditors Consideration'* to help its members in effectively discharging their obligations.

There will be issues to consider for this year's reporting as well as in future years. Every entity would need to consider the financial impact on itself and the areas of the financial statements that will be affected along with determining the required disclosures. Financial reporting areas that are likely to require close consideration include the following:

(1) Impairment of assets

Impairment of assets becomes the foremost financial reporting consideration, given that testing of impairment is predominantly based on the earnings realisation from a group of assets.

The **assumptions** such as the fall in demand, impact of lockdown, fall in commodity prices, decrease in market interest rates, manufacturing plant shutdowns, shop closures, reduced selling prices for goods and services, cost of capital, etc. may have a meaningful impact on the impairment testing performed by entities. Whilst most entities would perform impairment testing on an annual basis, the current Covid-19 situation would qualify for being an 'indicator', thereby requiring entities to test for impairment even in the interim.

(2) Going concern

Financial statements are prepared on a going concern basis unless management intends either to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

With business models being challenged especially in the travel, hospitality, leisure and entertainment segments, companies may need to consider the implications on the assessment of going concern and whether these circumstances will result in prolonged operational disruption which will significantly erode the financial position of the entity or otherwise result in failure.

It is the responsibility of management to make an assessment as to whether the entity is a going concern or otherwise. The unprecedented and uncertain nature of the pandemic makes it imperative for an entity to evaluate various scenarios that are possible and assess their impact on the assumption of going concern. Inability to satisfy the assumptions of going concern would lead to deviation from historical cost-based accounting and other impacts.

Management should also expect an informed and sometimes contrarian dialogue with auditors on the aspect of going concern.

(3) Valuation of inventory

With social distancing norms in place, entities may not have been able to carry out their annual physical inventory count fully or even partially on the cut off date. Due to the lockdowns, auditors and companies may need to rely on additional alternate procedures to gain comfort on the position and valuation as on 31st March, 2020.

Companies would need to assess whether, on their reporting 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* and AS 2 – *Valuation of Inventories*.

Given the pandemic, net realisable value calculation will likely require more detailed methods and assumptions, e.g. write-down of stock due to lesser expected price realisation, reduced movement in inventory, expiry of perishable products, lower commodity prices, or inventory obsolescence. The usability of raw materials and work in progress may also require close consideration.

A typical question arises in relation to allocation of overheads to the valuation of inventory. If an entity ceases production or reduces production for a period of time, significant portions of unallocated fixed production overheads (e.g., rent, depreciation of assets, some fixed labour, etc.) will need to be expensed rather than capitalised, even if some reduced quantity of inventory continues to be produced.

(4) Lease and onerous contracts

The implications of *force majeure* provisions on contracts and leases remain to be tested. It is possible that there may be changes in the terms of lease arrangements or lessors may grant concession to lessees with respect to lease payments, rent-free holidays, additional days in subsequent period, etc. Such revised terms or concessions shall be considered while accounting for leases which may lead to the application of accounting relating to the modification of leases. However, generally anticipated revisions are not taken into account.

Some entities may encounter situations wherein certain contracts may become onerous to perform. Ind AS 27 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Price erosions, long-term commitment, salvage discount, commitment of additional performance are certain triggers to evaluate whether a contract has turned onerous. As soon as a contract is assessed to be onerous, a company applying Ind AS 37 records a provision in its financial statements for the loss it expects to make on the contract.

(5) Expected credit loss (ECL)

ECL is an expectation-based probability weighted amount determined by evaluating a range of possible outcomes. It enables entities to make adequate provisions for non-realisation of financial assets including trade receivables.

Ind AS 109 – *Financial Instruments* requires an entity, amongst other matters, to also evaluate the likelihood of the occurrence of an event if this would significantly affect the estimation of expected losses of financial assets. In assessing the expected credit loss, management should consider reasonable and supportable information at the reporting date. Covid-19 impact would require to be factored in the ECL probability model of entities.

Expected credit losses may increase due to an increase in the probability of default for financial assets. Additionally, the effects of the coronavirus may trigger a significant increase in credit risk, and therefore the recognition of a lifetime ECL provision on many financial assets.

Event-based provisioning in relation to specific instances, like a customer turning insolvent or a specific financial investment getting affected, would continue to be factored in irrespective of the ECL.

(6) Revenue recognition and borrowing costs

Ind AS 15 – *Revenue from Contracts with Customers* often requires a company to make estimates and judgements determining the timing and amount of revenue to be recognised. Covid-19 may result in a likely increase in sales returns, decrease in volume discounts, higher price discounts, etc. Entities may need to account for returns and refund liabilities towards the customers whilst recognising the revenue.

Ind AS 115 requires an entity to defer a component of revenue to be recognised when the contract includes variable consideration. This may result in some entities recognising a contract liability rather than revenue, if significant uncertainty exists surrounding whether the entity will realise the entire consideration.

Separately, the guidance on borrowing costs requires an entity to suspend the capitalisation of borrowing costs to an asset under construction for such extended periods that the actual construction of the asset is suspended.

(7) Government grant

Governments may support entities with monetary and non-monetary measures, but such benefits may be one-time events or spread over time.

Entities may need to establish an accounting policy

regarding government assistance which needs to be appropriate and in line with the requirements of Ind AS 20 – *Accounting for Government Grants and Disclosure of Government Assistance*. It is essential to distinguish between government assistance and government grants and ensure that grants are recognised only when the recognition criterion in Ind AS 20 is met. Some of the government assistance may involve deferral of tax payments or other tax allowances. The accounting treatment of tax allowances may need to be accounted for under Ind AS 12 – *Income Taxes* rather than Ind AS 20.

The current relaxation by the Reserve Bank of India allowing a moratorium on loan instalments may not qualify as a government grant.

(8) Deferred tax

Ind AS 12 – *Income Taxes* requires that the measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

Covid-19 could affect future profits and / or may also reduce the amount of deferred tax assets or create additional deductible temporary differences due to various factors (e.g. asset impairment, non-utilisation of available losses, change in projections). Entities having deferred tax assets on account of accumulated tax losses would need to reassess their measurement with a newer set of business projections.

Entities may have considered the assumption of 'indefinite reinvestment' and not recognised deferred tax on accumulated undistributed earnings of subsidiaries. Such assumptions may need to be revisited to determine if they remain appropriate given the entity's current cash flow projections.

(9) Fair value and hedge accounting

Ind AS 113 – *Fair Value Measurement* recognises the fact that observable inputs being considered for deriving fair value may be either of (i) observable market price (quoted price in an active market – Level 1) or (ii) application of valuation techniques (Level 2 and Level 3).

With 1,500 companies trading at their 52-week low on the Bombay Stock Exchange, the fair value measurement considered by entities may need a re-look across all three methods of observable inputs.

While volatility in the financial markets may suggest that the prices are aberrations and do not reflect fair value, it would not be appropriate for an entity to disregard market prices at the measurement date, unless those prices are from transactions that are not orderly.

The financial assumptions in a valuation model like discounting rate, weighted average cost of capital, etc. that are considered in a Level-3 valuation would need a reassessment.

Hedge effectiveness assessment is required to be performed at the inception and on an on-going basis at each reporting date or in case of a significant change in circumstances, whichever occurs first. The current volatility in the markets may result in an entity requiring to either re-balance the hedge where applicable, or discontinuing hedge accounting if an economic relationship no longer exists, or the relationship is dominated by credit risk. Certain opportunistic and speculative transactions may also take place.

When a hedging relationship is discontinued because a forecast transaction is no longer highly probable, a company needs to determine whether the transaction is still expected to occur. If the transaction is:

(i) still expected to occur, then gains or losses on the hedging instrument previously accumulated in the cash flow reserve would generally remain there until the future cash flows occur; or

(ii) no longer expected to occur, then the accumulated gains or losses on the hedging instrument need to be immediately reclassified to profit or loss.

(10) Disclosures and management guidance

Transparent disclosures should be made on the effects and risks of this outbreak on the entity. The Securities and Exchange Commission instructed publicly traded companies to provide 'robust' disclosures on the impact of Covid-19 on their operations and results. Entities would need to disclose the impact of Covid-19 on their performance, including qualitative aspects of the business.

Difficult times also warrant accuracy in guidance; in an uncommon move, leading Indian bell-wether companies like **Wipro and Infosys have refrained from giving any annual guidance to their shareholders for F.Y. 2020-21, citing the uncertain impact of Covid-19.**

The relevance of an audit effort on the financial statements

is further emphasised in uncertain times like these. **Some of the common questions that auditors could encounter would include:**

(A) Have the risk considerations relevant to an entity changed, thereby requiring an amendment to the audit approach?

Standards on auditing require an auditor to identify and assess the risk of material misstatements and materiality in planning and performing an audit. This assessment may have been made during the earlier half of the financial year 2019-20 and the audit procedures tailored on the basis of such earlier assessment. Due to Covid-19 and its far-reaching implications, the risk considerations relevant to an entity may change significantly, thereby requiring an auditor to revisit the audit plan, materiality and the approach to testing.

The perfect storm that Covid-19 offers has the potential to usurp good and healthy business models and push profitable companies into a survival challenge. It would be important for auditors to revisit the audit plan and the risk considerations once again given the exposure an entity would have to Covid-19.

(B) Have the audit procedures been compromised on account of restrictions, lockdowns and social distancing?

Auditors may face a challenge in performing routine audit procedures during times of lockdown, social distancing, travel restrictions, lesser access to management teams, etc. Typically, audit procedures that have either a physical work-stream or dependency on a third party are likely to get impacted. These could include physical verification of inventory, cash on hand reviews, seeking external balance confirmations, requiring comfort from component auditors, etc.

SA 501 requires the auditor to observe some physical inventory counts on an alternative date if the attendance of physical counting cannot be performed at the year-end date, or perform alternative audit procedures where attendance of physical inventory counts is impracticable. The standard also requires an auditor to perform roll-back procedures to derive the desired comfort on inventory level on a reporting date.

Audit procedures should be simulated to understand the potential impacts on such procedures to be performed and alternate procedures identified to supplement or otherwise replace such an audit procedure.

(C) How does an auditor provide comfort on the operating effectiveness of internal financial controls given the altered way of working, such as work from home, no wet signatures, cloud dependency, etc.?

Standards on auditing require an auditor to assess the design and implementation along with the operating effectiveness of internal controls over financial reporting. The sudden impact of Covid-19 and the precautionary measures taken by governments across the world have resulted in newer work models of work from home, no wet signatures, cloud dependency, etc.

Auditors would need to evaluate the impact of such differentiated working models on the internal control framework and the desired reliance by the auditor on their operating effectiveness. If the level of expected controls reliance changes, it is important to document this and any other resulting changes to the planned audit response.

(D) Is Covid-19 an adjusting event or a non-adjusting event?

According to Ind AS 10 – *Events after the reporting date*, events occurring after the reporting period are categorised into two, viz. (a) Adjusting events, i.e. those that require adjustments to the amounts recognised in the financial statements for the reporting period, and (b) Non-adjusting events, i.e. those that do not require adjustments to the amounts recognised in the financial statements for the reporting period.

Entities and auditors would need to ascertain the impact of Covid-19 as either an adjusting or non-adjusting event given the peculiarity that the effects of Covid-19 and lockdown were prevalent in March, 2020 itself. Entities impacted by the Covid-19 pandemic will need to assess how these events have, and may in future impact their operations. Managements will need to consider the facts and apply critical judgement in assessing what specific events and, more importantly, the timing of those events, provide evidence of conditions that existed at the end of the reporting period in order to determine if an adjustment is required. If it is concluded as non-adjusting, the entity will need to determine if disclosure of the event is required.

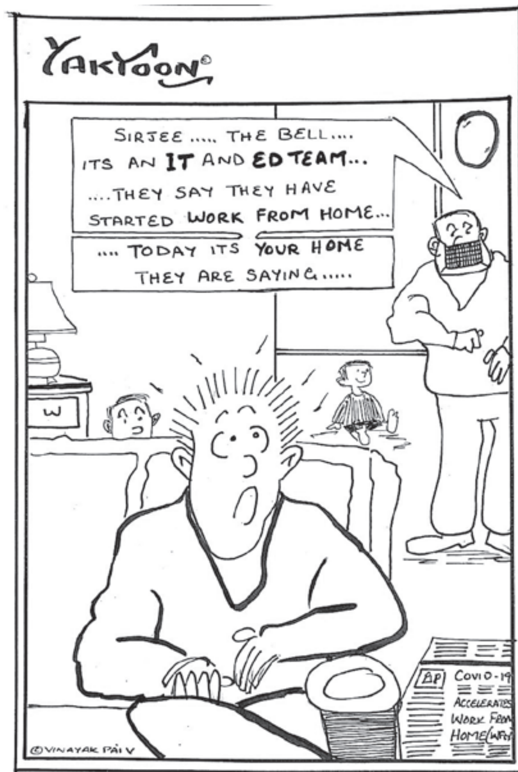
(E) Does Covid-19 require added consideration to emphasis of matter and in relation to going concern uncertainty?

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that in the auditor's judgement is of such importance that it is fundamental to users' understanding

of the financial statements, the auditor shall include an 'Emphasis of Matter' paragraph in the Auditor's Report. SA 706 also cites instances that may warrant an emphasis of matter observation by the auditor. One such instance is ***'A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.'*** Depending on the circumstances of the entity, the auditor may consider appropriate reporting as emphasis of matter.

When preparing financial statements, management is required to make an assessment of an entity's ability to continue as a going concern. In line with SA 570 (Revised), the auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

Depending on the circumstances, the auditor would need to consider whether to include a separate section 'Material Uncertainty Related to Going Concern' in the auditor's report. ■



You may not control all the events that happen to you, but you can decide not to be reduced by them

— Maya Angelou