

EDITORIAL

Covid-19 Pandemic and Financial Reporting Issues and Challenges

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“COVID-19 poses existential threats on the ability of a business to survive, which in turn have significant financial reporting impacts –from going concern and liquidity to recoverability and valuation of assets.”

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Abstract: This editorial discusses some of the financial reporting challenges and implications which are arising due to **COVID-19** occurrence for accounting and auditing professionals. The editorial note argues that the impacts of coronavirus spread are non-adjusting event for 2019 and impacts of the events will be reported and adjusted in the first quarter of 2020 only under interim reporting. Further, it discusses the likely impacts and challenges in some main accounting areas such as revenue recognition, impairment of non-financial assets, goodwill impairment, inventory valuation, fair value measurement, hedge accounting, provisions for bad debts etc. Additionally, going concern issues and audit evidence are also discussed because these are considered the grey areas for management and auditors as a lot of judgements are applied in dealing with them. The meaningful and timely disclosures of the likely effects of **COVID-19** on the financial position and operating performance as well as liquidity of company need to be made. The editorial note concludes that since the conditions are uncertain, therefore, to maintain the quality of financial information to the users, auditors should exercise professional skepticism while auditing the financial statements figures.

Key words: **COVID-19** pandemic, financial reporting challenges, International Accounting Standard Board, auditor, revenue recognition, financial position, impairment, fair value measurement, deferred taxation, going concern, audit evidence, skepticism.

INTRODUCTION

The advent of coronavirus pandemic has been a singular event and the subsequent continuous lockdowns have brought the business and human life to a standstill. This pandemic has an immediate impact on the business activity levels followed by a secondary impact on the measurement activities such as financial statements. Radigan (2020) states that the

COVID-19 pandemic has very high potential to create significant changes for professional accountants who are engaged in preparing company financial statements – and for auditors as well. At the same time, regulators around the world are advising issuers of the company’s financial statements to closely work with their audit committees and financial auditors to ascertain that their financial reporting, auditing, and review processes are as robust as practicable in the light of changing circumstances under **COVID-19** environment. The purpose of this editorial is to shed some light on the accounting and auditing challenges and implications that companies and professionals are going to face due to the **COVID-19** pandemic.

COVID-19, a unique event, has affected every aspect of human life and business activities. China informed the **World Health Organization** (WHO) on 31st December 2019 about the unusual cases of coronavirus in Wuhan. But detailed information about the symptoms and risks exposure of this virus was known to the world only during 2020. Therefore, from the accounting perspective, the emergence of coronavirus is considered a non-adjusting event for 2019 for most of the companies in several countries, since the main outbreak of the virus occurred in most part of the world amid January 2020. PwC (2020) also states that the spread of the coronavirus is a non-adjusting event. Additionally, when the companies authorised to issue their financial statements, perhaps they will be required to incorporate a comprehensive post-balance sheet review in the year-end. Dave and Mahanta, 2020, make an insightful observation:

“Any entity shall disclose the nature of the event, an estimate of its financial effect or a statement that such a financial effect cannot be made for each material category of non-adjusting event after the reporting period. In such cases, the reporting period for most of Indian companies will be October-December 2019 and they will have to declare the impact of the COVID-19 disruption in the next quarter”.

The impact of **COVID-19** may be considered an adjusting event for any reporting period ending as from 31 January 2020 as the full scale and impact of coronavirus disruptions will completely manifest during 2020.

The estimation of **COVID 19** effects is extremely difficult given the primary, secondary, and tertiary effects. The direct severe economic impact on the financial statements for many companies or groups will be the primary effect. The uncertainty of valuing assets and liabilities, will be a secondary issue. The tertiary issue will be the going concern assumption and a plethora of auditing issues. Accounting, financial reporting, and auditing are affected because the financials have been showing wider fluctuating valuations and unprecedented volatility in market variables. Gould & Arnold (2020) from IFAC state that many companies may like to

first report financial effects in interim financial statements (*IAS 34–Interim Financial Reporting*) because these may involve the greater use of accounting estimates. In this context, Laxminarayan (2020) argues that all published financial results progressively commencing from March 2020 quarter-end, will be closely scrutinized by shareholders, market participants as well as regulators.

ACCOUNTING AREAS MAINLY IMPACTED

The economic variables may be compelling companies in multiple industries to defer their non-essential spending. At the same time, companies are making concessions to their customers, borrowers, and lessees. Companies are paying salaries to employees when they are not working or there is no income generation. A large number of financial statement items are subject to difficult estimations. The quality of financial reporting may become questionable. Management and accountant's judgments would be required to determine whether events that took place after the end of the reporting period are adjusting or non-adjusting events. Management would be required to continuously review the events and their effects and update them.

Accounting professionals may have to apply a lot of their judgments as per the accounting standard concerning revenue recognition because under **COVID-19**, there is a shrinking of revenue and margins. The customer contracts may need to be evaluated due to changes in policy considerations in terms of price concessions, discount, refunds, performance bonuses, etc. Also, the contracts may not be honoured at all. It needs to be emphasized that under IFRS 15, understanding of contract terms and conditions is important before any revenue is recognised (ICAEW, 2020).

Similarly, company accounting professionals may need to give a closer look at the recognition of asset impairment losses because there has been a sharp fall in asset values across financial markets. The worldwide spread of coronavirus disease has caused a temporary closure of manufacturing plants. This has also led to restrictions on travel and import and export of goods (Tas, 2020). All these may be considered as an indicator of assets' impairment because companies are not able to recover the book value/carrying value either by using the assets or selling them. In other words, entities should consider whether they are experiencing any conditions such as store closures, decreased revenues, order cancellations, supply chain disruptions, or declines in share prices,. These changes may indicate that their assets should be tested for impairment.

Additionally, another grey area in financial reporting is goodwill impairment. Laxminarayan (2020) argues that this item is likely to bite companies with significant competitive acquisitions in the past. If the size of goodwill in the statement of financial position for the troubled industries is high, there is likely to be more scrutiny of such companies' income statements and its impact, a possible goodwill impairment charge may affect profitability for years to come.

Similarly, government actions to deal with the impact of the **COVID-19** outbreak involves support measures such as direct subsidies, exemptions of tax or reduction of taxes and credits, low-interest loans, or reduction in rents. Accountants should not overlook that these measures of government also have a substantial impact on financial reporting by companies.

The fair value measurement (because of uncertainty and fluctuations in the markets) is a particular item that is greatly to be impacted due to **COVID-19**. The company management has to make proper disclosures to enable users to understand whether or not the outbreak has been considered for fair value measurement. Furthermore, Gould and Arnold (2020) from IFAC, argue that fair value measurement concerning financial instruments and investment property, in 2020, may need to be reviewed ensuring that values do reflect the conditions at the balance sheet date. They further state that measurement will be based on:

“unobservable inputs that reflect how market participants would consider the effect of COVID-19 in their expectations of future cash flows related to the asset or liability at the reporting date”.

Certain key industries like heavy engineering, construction equipment, automobiles, and other capital goods are likely to be affected severely on their income statement because of inventory write-downs or greater uncertainties involved in revenue recognition.

Regarding hedge accounting, the IASB., (2020a) guidelines point out that hedged items in a cash flow hedge may also be impacted due to **COVID-19** occurrence. These include:

- i. The sale or purchase volumes that fall below the levels originally forecasted;
- ii. Planned debt issuances that are delayed or cancelled such that interest payments fall below levels originally forecasted; and Business acquisitions or disposals that are delayed or cancelled, and
- iii. Business acquisitions or disposals that are delayed or cancelled.

The Board's guidelines further state that (IASB, 2020a):

"In case the entity ascertains that the forecasted transaction is no longer highly probable, but still is expected to occur, the entity must discontinue hedge accounting prospectively and defer the gain or loss on the hedging instrument that has been recognised in other comprehensive income accumulated in equity until the forecasted transaction occurs".

Inventory valuation is yet another important accounting area on which **COVID-19** outbreak will have significant adverse impacts. This is due to forced plant shutdowns, considerable decline in the net realizable value because there is reductions in demand, and possibly non-performance of sales and purchase contracts. Counting of year-end stock might be challenging and impossible, therefore, sound judgement of the management and auditor would be very important.

Additionally, if suppliers are unable to meet their obligations under control due to temporary closer of operations, they would need recognition of provisions, therefore, customers contracts would become onerous. Management and accountants will have to apply their judgement for reasonable estimates for provision and appropriate disclosures in the financial statements (e.g., see, KPMG, 2020a).

It is posited that the provision for bad debts is usually based on "Expected Credit Losses (ECL)". Due to coronavirus occurrence, these models might have lost their relevance as an indicator of future expectations of bad debts because these models are built based on the company's historical experiences. Hence, they need to be suitably updated in light of the prevailing conditions (Khatari, 2020).

Four areas may be affected by **COVID-19** pandemic related to deferred taxation. These include: recognition of deferred tax assets, deferred tax liabilities associated with investment subsidiaries, expected manner of reversal and interim reporting tax rate.

It is argued by tax experts (e.g. Grant Thornton, 2020), that for established businesses having history of profitability, deferred tax assets are often recognized without debate for deductible temporary differences.

For other companies, deferred tax assets are recognized for non-capital losses, but only when supported by convincing evidence of future taxable profit. Tax experts further state that when it is no longer probable that future taxable profit will be available, the corresponding deferred tax asset can no longer be recognized (see, Grant Thornton, 2020).

Grant Thornton (2020) states that foreign subsidiaries having accumulated foreign profit is usually re-invested in overseas operations

or used to finance further global expansion. Under COVID-19, entities may be assessing whether these earnings should now be repatriated to the parent entity's country through dividends. Grant Thornton (2020) opines that dividends received by the taxpayer may have to have a full dividend deduction attached to them provided they are paid out of active business earnings of the foreign subsidiary. With the **COVID-19** pandemic, preparers of financial statements should be modelling possible contingency plans that include needing to fund future deficits associated with any resulting economic downturn the entity might encounter (Grant Thornton, 2020).

Furthermore, it is argued that as per IAS 12, taxable and deductible temporary differences are required to be measured using the rates at which these differences are expected to reverse and corporate income tax rate is generally applicable to the profit of the entity

IAS 34 requires the use of the so called, effective tax rate (ETR) method, However, the composition of taxable income could be highly uncertain due to government programmes. Entities may also have to assess the receipts of Government Assistance: whether any government assistance received is within the scope of IAS 12 or IAS 20 'Accounting for Government Grants and Disclosure of Government Assistance'.

Other areas such as net realizable value, risk exposure, other accounting estimates, loan modifications, government dues will have financial reporting implications and challenges for companies and accounting professionals.

GOING CONCERN ISSUES

The going concern issues will pose difficult problems in terms of obtaining proper documentation and evidence gathering and forecasting for the auditors. They may have to put additional efforts and use procedures to determine the appropriate "going concern" issues of the organization. IASB (2020b) guidelines state that it is the responsibility of the management to assess the entity's ability to continue as a 'going concern'. Where it is relevant, management should take into consideration, the existing and anticipated effects of the outbreak of **COVID-19** on the entity's activities in its assessment of the appropriateness of the use of the "going concern" basis. Furthermore, the IASB (2020b) guidelines state that "*the going concern assessment needs to be performed up to the date on which the financial statements are issued*". Others (Accountancy Europe, 2020) argue that companies which are likely to be adversely affected by the coronavirus such as small businesses or in areas of travel, media, leisure and hospitality, retail and aviation, etc. need to consider 'going concern' issues. Further, it is argued

by accounting professionals that recoverability of debtors is going to be a much bigger issue than usual and it may impact going concern (ICAEW, 2020). Also, there would be a need to perform sensitivity analyses for such businesses to ascertain whether there is any material uncertainty on their ability to continue as a “going concern”.

Another key issue related to going concern is the cash flow. The question is whether a business has sufficient cash to survive in the next six to 12 months? It is certain that under **COVID-19**, companies may experience cash flow challenges due to disrupted operations, lost revenues, and higher operating costs (Tas, 2020). It may be possible that auditor’s risk assessment, and because of new threats, there is a need to revise the significant risks, for example, about a company’s liquidity position. In this context, KPMG (2020b) states that *“At a fundamental level, for certain companies, the current situation casts significant doubt on their ability to continue as a going concern, particularly if large debt repayments are due within the next 12 months”*. As a result, such events require additional disclosures in the financial statements, and perhaps the auditor may have to mention this in the audit report.

OBTAINING EVIDENCE

Currently, there is a ban or restrictions on travel from the law enforcement bodies, therefore, unanticipated barriers and challenges are faced by auditors in securing reliable information to carry out the audit of their clients’ financial statements. Auditors have to continue to fully comply with the International Standards in Auditing (ISAs) even under current conditions. However, the regulators have been expressing concerns that auditors may have difficulty gaining access to the evidence and people they need to support their audit opinion.

Further, the audit planning done by the auditors may not be fully workable because they may fail to provide anticipated audit evidence, forcing auditors to change their approaches. For example, clients’ banks and debtors may not provide confirmations on the transactions or outstanding balances as reliable audit evidence. The auditors need to consider alternative methods or the use of technology in sharing data or hosting virtual meetings perhaps as mentioned in **ISA-500** to obtain audit evidence. More importantly, related to audit evidence, auditors need to understand that entities’ internal controls are normal systems and they are still working or have some of the risks and associated controls changed?

Furthermore, accounting and auditing professionals (e.g., Accountancy Europe, 2020) also suggests that auditors need to consider the difficulties faced by management in preparing their company’s future projections. They

should recognize the highly fluid situation and greater uncertainty involved with their businesses due to coronavirus. These projections may also change in short periods according to changing situations and the impact of the coronavirus. However, auditors may have to conduct proactive discussions with their client companies on the effects of the **COVID-19** operations, business, and reporting timetables (Accountancy Europe, 2020).

CONCLUDING REMARKS

Undoubtedly, the scale and speed of the impact of coronavirus on the world economy have been unprecedented. The economic environment, markets, and financial reporting are expected to continue to face significant challenges and risks in the foreseeable future. Companies are now experiencing conditions often associated with a general economic downturn. Therefore, company management, accounting, and auditing professionals are expected to address the financial effects of the **COVID-19** outbreak in the preparation of financial statements for annual or interim reporting periods ending in 2020. The meaningful and timely disclosures of the likely effects of **COVID-19** on the financial position and operating performance as well as the liquidity of the company and their communication are very important to regain the trust of the stakeholders. Furthermore, some experts believe that reporting of likely impact of **COVID-19** is not limited only to interim and annual financial statements, but also need to be updated in risk management disclosures as well as in Management Discussion & Analysis (MDA). To enhance the quality of financial information to the users, auditors exercise professional skepticism while auditing the financial statements figures.

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