Summary of ICAI Advisory on Impact of Corona Virus on Financial Reporting

Apart from the health and safety of mankind, COVID-19 has unfavourably affected the economic environment which in turn has consequential impact on the results in the financial statements and reporting. There is also a need to advise the preparers of financial statements to ensure that the potential impact of COVID-19 is suitably considered in preparing and reporting their financial statements for the year ended March 31, 2020. Considering all the above factors, in order to guide the preparers and auditors, the Institute of Chartered Accountants of India (ICAI) has developed an Advisory on **"Impact of Coronavirus on Financial Reporting and the Auditors Consideration"** highlighting few important areas which require particular attention in respect of financial statements for the year 2019-20. It is prepared for entities where Ind-AS is applicable and entities to whom Accounting Standards Rules, 2006 is applicable and non-corporate entities to whom AS issued by ICAI is applicable.

There are few important areas during these challenging times as given below:

- Inventory Measurement
- Impairment of Non-Financial Assets
- Financial Instruments (Impairment Losses, Fair Value Measurement and Hedge Accounting)
- Leases
- Revenue
- Provisions, Contingent Liabilities and Contingent Assets
- Modifications or Termination of Contracts or Arrangements
- Going Concern Assessment
- Income Taxes
- Consolidated Financial Statements
- Property, Plant and Equipment
- Presentation of Financial Statements
- Borrowing Costs
- Post Balance Sheet Events
- Interim Financial Reporting

Inventory Measurement

In accordance with Ind AS 2, Inventories, and AS 2, Valuation of Inventories, it might be necessary to write down inventories to net realisable value due to reduced movement in inventory, decline in selling prices, or inventory obsolescence due to lower than expected sales.

Entities should assess the significance of any write-downs and whether they require disclosure in accordance with Ind AS 2/AS 2 as well as paragraph 98 (a) of Ind AS 1, Presentaion of Financial

Statements, and paragraph 14(a) of AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. It is unlikely that the normal production capacity is to be reviewed for allocating fixed production overheads for the year 2019-2020, because of adverse impact on the utilisation of the production capacity due to the impact of coronavirus on the overall economy or the segment (s) in which the entity is operating.

Impairment of Non-Financial Assets

Due to COVID 19, there might be temporary ceasing of operations or an immediate decline in demand or prices resulting in lowering of revenues and profitability and reduced economic activity. These are the factors that the management may consider as the indicators that may require impairment testing for the purpose of Ind AS 36 and AS 28.

Critical Factors to Consider

The management needs to consider whether:

- contraction in economic activity due to the outbreak of COVID 19 is considered to be an impairment indicator at the reporting date, which results in an impairment assessment;
- assumptions used for impairment testing and to determine the recoverable amounts before the outbreak of COVID 19 requires any change;
- the assumptions used to determine discount rate to measure the recoverable amount require any adjustments;
- the forecasts or budgets for future cash flows prepared by managementshould be updated to reflect the impact of COVID 19;
- market assumptions used to determine fair value for recoverable amounts needs reconsideration;
- reasonable assumptions are taken in estimating the value-in-use and fair value less costs of disposal and ensure that the impairment loss, if any, is estimated reliably.

Goodwill impairment

Due to COVID-19, there might be significant changes with an adverse effect in operations of a cash generating unit to which goodwill is allocated and therefore requiring additional focus and attention while testing of impairment of goodwill as at March 31, 2020.

Financial Instruments

The widespread contraction in economic activity across the globe due to the rapid spread of COVID-19 is likely to have an impact on the quantification of ECL and classification of financial assets into 3 buckets for recognition and measurement of impairment losses. In this context, following are important factors to be considered by the preparers.

Critical Factors to Consider

- Recognition of 12 months ECL versus Lifetime ECL is based on segregation of credit exposures into 3 buckets viz. Stage 1- those with no significant increase in credit risk, Stage -2 those with significant increase in credit risk and Stage 3- Credit impaired. In case of certain financial assets such as Trade Receivables where the simplified approach is applicable, this segregation of credit exposures into 3 buckets is not required.
- Measurement of ECL- Adverse impact on the business of borrowers or debtors may impact the following credit risk parameters :
  - Risk of default (probability of default) i.e. the likelihood of default by the borrower may have increased significantly due to reduced economic activity;
  - Estimated amount of the loss itself in the event of default (loss given default). Contraction in economic activity and its impact on consumers may have affected value of collaterals and business cash flows adversely affecting the expected amount of loss;
  - In this period of substantial business dislocation, borrowers may tend to fully utilise undrawn limits and loan commitments, which in turn would impact another credit risk parameter i.e. exposure at default.
- ECL requirement of Ind AS 109, the measurement of ECL is expected to consider current as well as forecasted macro-economic conditions and more than one scenario. Entities may need to develop one or more scenarios considering the potential impact of COVID-19.
- Ind AS 109 – Appendix A states that a financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flow of the financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about various events, for example, the lender(s) of the borrower, for economic or contractual reasons relating to the borrower’s financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider.
- Entities may also need to consider the impact of any Prudential Regulatory actions to sustain the economy such as loan repayment holidays, reduction in interest rates etc.

- In respect of Ind AS 107, Financial Instruments Disclosures, entities may need to disclose the impact of COVID-19 on various credit related aspects such as methods, assumptions and information used in estimating ECL, policies and procedures for valuing collaterals etc.
- If the entity is unable to assess the impact of COVID-19 in estimating the impairment loss due to the inadequacy of information, the same should be disclosed appropriately.

Fair Value Measurement

In this context, the following are the critical factors to be considered in determining fair value both for measurement or disclosure requirements by the preparers.

Critical Factors to Consider

- Ind AS 113 recognises the fact that there are different ways in which fair value is determined i.e. it can be based on observable market price (quoted price in an active market –Level 1) or application of valuation techniques (Level 2and Level 3) as of the reporting date.
- The current financial and capital market environment across the globe has got affected by the rapid spread of COVID-19 and may have developed the following features.
  - Significant volatility or indications of the significant decline in market prices of financial instruments like equity, bonds and derivatives.
  - Significant decrease in volume or level of activity.
- The above features may need adequate management consideration and professional judgment to determine whether the quoted prices are based on transactions in an orderly market. It may not be always appropriate to conclude that all transactions in such a market are not orderly. Preparers should be guided by the application guidance in Ind AS 113 that indicates circumstances in which the transaction is not considered an orderly transaction.
- Preparers using valuation techniques may have to consider the impact of COVID-19 on various assumptions including discount rates, credit-spread/counter-party credit risk etc.

Hedge Accounting

Critical Factors to Consider

- The standard permits a highly probable forecast transaction to be a qualifying hedged item. If entities have adopted cash-flow hedge accounting for certain forecasted transactions, they should assess whether the transaction still qualifies as a highly probable forecast transaction considering their business environment.
- Entities will need to assess any hedge ineffectiveness and record the impact of that in profit and loss.

- Estimate the fair value of derivatives, including paying special attention to underlying assumptions of derivatives, e.g., forward curve of interest rate, foreign currency, commodity etc.

Leases

- Due to COVID-19 there can be changes in the terms of lease arrangements or lessor may give some concession to the lessee with regard to lease payments. Such revised terms or concessions shall be considered while accounting for leases. However, anticipated revision should not be taken into account.
- Discount rate used to determine present value of minimum lease payments of new leases may need to incorporate any risk associated with COVID-19.
- If any compensation is given/declared by the Government to the lessor for providing concession to the lessee, it should be considered whether the same needs to be accounted for appropriately as per AS 19. Whether any assistance received from government are government grants under AS 12.
- Entities will need to determine whether as a result of COVID -19, any lease arrangement has become onerous. The same should be accounted for as per AS 29.

Revenue

- Due to COVID-19, there could be likely increase in sales returns, decrease in volume discounts, higher price discounts etc. Under Ind AS 115, these factors need to be considered in estimating the amount of revenue to recognised, i.e., measurement of variable consideration.
- Ind AS 115 also requires disclosure of information that allows users to understand the nature, amount, timing and uncertainty of cash flows arising from revenue. Therefore, entities may have to consider disclosure about the impact of COVID-19 on entities revenue.
- Entities to whom AS is applicable, may have postponed recognition of revenue due to significant uncertainty of collection in view of the impact of COVID-19.

Provisions, Contingent Liabilities and Contingent Assets

- As a result of COVID -19, some contracts may become onerous for reasons such as increase in cost of material/labour, etc. Management should consider whether any of its contracts have become onerous. In case of Entities to whom Ind AS is applicable, Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets requires assets dedicated to a contract to be tested for impairment before a liability for an onerous contract is recognised. In case of Entities to whom AS is applicable, the same should be accounted for as per AS 29.

- Management should disclose that it has assessed whether executory contracts are onerous due to the adverse impact of COVID -19. If, the management is unable to assess whether some of the executory contracts have become onerous due to inadequacy of information, the same should be disclosed.
- Due to COVID-19, there is a need for exercising judgement in making provisions for losses and claims. A provision may be accounted for only to the extent that there is a present obligation for which the outflow of economic benefits is probable and can be reliably estimated.

Modifications or Termination of Contracts or Arrangements

- It may also be noted that the entities may modify or terminate certain contracts which may be within the scope of other Ind ASs or ASs or Guidance notes mentioned below. Entities are advised to consider the specific requirements of these standards and guidance note to account for these modifications or terminations.

- Entities to Whom Ind AS is applicable
  - Ind AS 19, Employee Benefits
  - Ind AS 102, Share-based Payments
  - Ind AS 109, Financial Instruments and Ind AS 32 Financial Instruments - Presentation
  - Ind AS 104, Insurance Contracts For insurance companies this is routine; events like earthquake, huge floods, war situations, etc.
  - Ind AS 115, Revenue from Contracts with Customers

- Entities to Whom AS is applicable
  - AS 15 Employee benefits (revised 2005)
  - Guidance Note on Accounting for Employee Share Based Payments
  - Guidance Note on Accounting for Derivative Contracts (Issued 2015)
  - AS 7 Construction Contracts (revised 2002) AS 9 Revenue Recognition) Guidance Note on Accounting for Real Estate Transactions (revised 2012)

Going Concern Assessment

- Entities to whom Ind AS is applicable, Management of the entity should assess the impact of COVID-19 and the measures taken on its ability to continue as a going concern. The impact of COVID-19 after the reporting date should also be considered and if, management after the reporting date either intends to liquidate the entity or to cease trading, or has No realistic alternative but to do so, the financial statements should not be prepared on going concern basis. Necessary disclosures as per Ind AS 1 shall also be made, such as material uncertainties that might cast significant doubt upon an entity's ability to continue as a going concern.

- Entities to whom AS is applicable, The impact of COVID-19 after the balance sheet date should also be considered in assessing whether going concern assumption is appropriate or not. Events occurring after the balance sheet date may indicate that the enterprise ceases be a going concern.

Income Taxes

- Entities to whom Ind AS is applicable, COVID-19 could affect future profits and/or may also reduce the amount of deferred tax liabilities and/or create additional deductible temporary differences due to various factors (e.g., asset impairment). Entities with deferred tax assets should reassess forecasted profits and the recoverability of deferred tax assets in accordance with Ind AS 12, Income Taxes, considering the additional uncertainty arising from the COVID-19 and the steps being taken by the management to control it.

- Entities to whom AS is applicable, Entities with deferred tax assets should reassess forecast profits and the recoverability of deferred tax assets in accordance with AS 22.

Consolidated Financial Statements

- Entities to whom Ind AS is applicable, Ind AS 110 prescribes that the financial statements of parent and subsidiaries used in the preparation of the consolidated financial statements are usually drawn upto the same date. It may be noted that in any case, the difference between the reporting dates should not be more than three months.

- Entities to whom AS is applicable, AS 21 prescribes that the financial statements of parent and subsidiaries used in preparation of the consolidated financial statements are usually drawn upto the same date. It may be noted that in any case, difference between the reporting dates should not be more than six months.

Property Plant and Equipment (PPE)

- Ind AS 16 and AS 10 require that useful life and residual life of PPE needs revision in annual basis. Due to COVID-19, PPE can remain under-utilised or not utilised for a period of time. It may be noted that the standards require depreciation charge even if the PPE remains idle. Further, COVID-19 impact may have affected the expected useful life and residual life of PPE.

- The management may review the residual value and the useful life of an asset due to COVID 19 and, if expectations differ from previous estimates, it is appropriate to account for the change(s) as an accounting estimate 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.

Post Balance Events (Ind AS 10 and AS 4)

- Entities must disclose significant recognition and measurement uncertainties that might have been created by the outbreak of the COVID -19 in measuring various assets and liabilities. They should also disclose how they have dealt with the impact of COVID -19 on the financial position and financial performance of the entity.

Interim Financial Reporting (Ind AS 34 and AS 25)
(Currently, this section may be applicable to a limited set of entities)

- Ind AS 34/AS 25 requires that an entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. This implies that additional disclosure should be given to reflect the financial impact of the COVID-19 and the measures taken to contain it. This disclosure should be entity specific and should reflect each entity's circumstances. Where significant, the disclosures required by paragraph 15B in Ind AS 34 should be included.

- The preparers may consider making suitable disclosures in the Management Discussion and Analysis section of the Annual Report about the effect of Coronavirus (COVID-19) on the overall risks to the businesses in which the entity is engaged.