# Technical Alert

**COVID 19'S IMPACT ON BUSINESS, AUDIT AND FINANCIAL REPORTING**

COVID-19 has already had a significant impact on global financial markets, and as an inevitable result, will also have financial reporting implications.

Another consequence of the pandemic is a desperate economy where businesses are struggling to stay afloat. The audit and accounting implications of these economic conditions are significant and the need for **professional scepticism** cannot be over-emphasised.

This alert sets out initial thoughts on matters that may be of relevance for accountants and auditors to consider during this time and practitioners should take note of the date of issuance of the guidance as this remains an evolving situation.

The alert is not intended to be comprehensive but serves to highlight those aspects which may be of relevance to practitioners and businesses with a number of references to other materials available as at the date of publication.

## Contents

## Impact on businesses

Covid-19 is likely to lead to significant **business disruption** in the production of goods and the provision of services for example:

- Supply chain disruption;
- Customer failure/drop in demand;
- Closure of stores/facilities;
- Employee absence;
- Loss of brand value;
- Interruptions of production;
- Delays in planned business expansions;
- Inability to raise financing;
- Increased volatility in the value of financial instruments; or
- Reduced tourism, disruptions in nonessential travel and sports, cultural and other leisure activities.

An interesting and helpful PWC publication provides a Strategy and Operating Model Checklist for business leaders to ensure they consider necessary factors in response to the COVID 19 crisis.

Covid-19 could significantly impact **liquidity** including:

- Prolonged pressure on cash flows;
- Deteriorating cash conversion ratios;
- Counterparty failure to pay;
- Withdrawal of uncommitted facilities; and
- Uncontrolled inconsistencies between forecast and actual cashflows.

COVID 19 could impact on the entities business to **access capital**:

Operating liquidity constraints may cause some entities to place more reliance on access to external capital. This could result in:

- Highly leveraged businesses;
- Reduced headroom or breach of covenants as a result of challenging revenue growth/trading/ productivity;
- Refinancing risk;
- Uncertainty around a business's ability to access to new lines of funding on a timely basis; or
- Deterioration of relationships with providers of finance.

Covid-19 could lead to **contractual non-compliance** such as.

- Conduct issues for regulated businesses;
- Contractual liabilities for non-delivery of services;
- Large defined benefit pension obligations; or

- Breaches of covenants.

Below is an extract from a Deloitte publication: IFRS in Focus, Accounting Considerations Related to Coronavirus Disease 2019 relating to Covenant breaches:

*"Unstable trading conditions and shortages of cash flows in the affected regions may increase the risk that entities breach financial covenants. Entities should consider how the breach of a covenant would affect the timing of repayment of the related loan and other liabilities (e.g. if it becomes repayable on demand) and how it affects the classification of the related liabilities at the reporting date.*

*If a breach occurs on or before the end of the reporting date and the breach provides the lender with the right to demand repayment within 12 months of the reporting date, the liability should be classified as current in the entity's financial statements in the absence of any agreements made prior to the reporting date that give the entity a right to defer payment beyond 12 months after the reporting date.*

*In contrast, a breach of loan covenants after the reporting date is a non-adjusting event that should be disclosed in the financial statements if the information is material. A breach after the reporting date could also affect the entity's ability to continue as a going concern."*

Refer to a PWC publication: In depth A look at current financial reporting issues where covenant breaches are also discussed.

## Going concern assumption

Management's assessment of going concern would in most instances be significantly impacted by the uncertainty in the economy and therefore the prospects of the entity.

An important consideration is that the going concern evaluation based on the prior year as a predictor is unlikely to be an appropriate basis on which to base forecast information.

Similarly, all business continuity uncertainties would require additional scrutiny and challenge by auditors.

For more on the impact of COVID 19 on the going concern assumption and its impact on the audit report, refer to the below helpful resources:

- ICAEW Article Coronavirus, going concern and the auditor's report.
- Ernst and Young Article IFRS accounting considerations of the COVID-19 outbreak.
- Deloitte publication: IFRS in Focus, Accounting Considerations Related to Coronavirus Disease 2019
- KPMG publication First Notes: COVID 19: Potential impacts on financial reporting

## Subsequent events

Extract from [Deloitte publication: IFRS in Focus, Accounting Considerations Related to Coronavirus Disease 2019]:

> *"At the end of each reporting period, entities should carefully evaluate information that becomes available after the reporting date but before the issuance of the financial statements. The amounts in the financial statements must be adjusted to reflect events that provide evidence of conditions that existed at the end of the reporting period. Additionally, if non-adjusting events (those that are indicative of conditions that arose after the reporting period) are material, an entity would be expected to disclose the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made.*
>
> *With respect to reporting periods ending on or before 31 December 2019, it is generally appropriate to consider that the effects on an entity are the result of events that arose after the reporting date (e.g. decisions made in response to the COVID-19 outbreak) that may require disclosure in the financial statements but would not affect that amounts recognised.*
>
> *For subsequent reporting periods, COVID-19 may affect the recognition and measurement of assets and liabilities in the financial statements."*

For more on the impact of COVID 19 on the subsequent events evaluation refer to the below helpful resources:

- [KPMG publication First Notes: COVID 19: Potential impacts on financial reporting]

## Judgements and estimates disclosure

Many accounting estimates are impacted by the COVID 19 crisis, especially those that rely on forecasts of earnings and cashflows.

Any factors which are a source of material judgements and uncertainties should be appropriately disclosed as required by IAS 1 Presentation of Financial Statements. This is particularly important during the COVID 19 crisis as estimates and valuations are likely to fluctuate significantly and the basis for these fluctuations is likely to be material to the users of the financial statements.

## Valuations

Uncertainties around Covid-19 could lead to significant fluctuations in asset values triggering covenant compliance issues and lead to liquidity challenges.

For valuations relying on unobservable data and/or expected future cash flows care should be taken to make use of assumptions relevant to the current economic situation and expected cash flows available at the period-end. This may give rise to more uncertainty and where balances are material the disclosures noted re estimates above become crucial.

For more on the impact of COVID 19 on the valuations refer to the below helpful resources:

- Deloitte publication: IFRS in Focus, Accounting Considerations Related to Coronavirus Disease 2019
- KPMG publication First Notes: COVID 19: Potential impacts on financial reporting
- PWC publication: In depth A look at current financial reporting issues

## Impairments (Inventory, non-financial assets, and ECL)

Inventory

The calculation of Net Realisable Value, which is a key element in the value of inventor in an entity's financial statements could be significantly impacted by the COVID 19 crisis and should be ab area of focus for financial managers/accountants/directors as well as the entities auditors.

It is also expected that, should production be reduced, the costing of inventory items could be significantly impacted and unallocated overheads could need to be recognised in profit/loss.

For auditors, it is important to consider the requirements of ISA501: Audit Evidence: Specific Considerations for Selected Items with regards to inventory counts.

Non-financial assets

The current global and local circumstance would in most instances be considered a triggering event which would require management of entities to perform an impairment assessment of assets (in addition to the requirement to perform an impairment test at least annually of goodwill and intangible assets with an indefinite useful life).

In assessing the potential need for impairment estimates of future cash flows and earning is required which would be significantly impacted by a crisis such as the one faced at the moment.

Refer to for further guidance on this matter:

- Deloitte publication: IFRS in Focus, Accounting Considerations Related to Coronavirus Disease 2019
- PWC publication: In depth A look at current financial reporting issues

Expected credit losses

COVID 19 is likely to impact the ability of a significant number of borrowers to meet their obligations in terms of loan agreements. The possibility/probability of default is therefore increased which impacts the assessment/estimation of expected credit losses as required by IFRS 9.

Refer to for further guidance on this matter:

- Deloitte publication: IFRS in Focus, Accounting Considerations Related to Coronavirus Disease 2019
- PWC publication: In the spotlight A banking industry focus on IFRS 9 expected credit losses
- IFRS publication: IFRS 9 and COVID-19: Accounting for expected credit losses applying IFRS 9 Financial Instruments in the light of current uncertainty resulting from the COVID-19 pandemic.

## Other considerations that may be of relevance to practitioners:

- Considerations for the audit of groups
- Interim financial statements
- Onerous contracts provisions
- Accounting Estimates
- Revenue recognition
- Government grants
- Employee benefits
- Internal controls over financial reporting
- Lease accounting
- Disclosures in annual reports
- Disclosures in AFS
- Hedging relationships
- Insurance recoveries related to business interruptions
- Employment termination benefits
- Share-based compensation performance conditions and modifications
- Contingent consideration in contractual arrangements
- Modifications of contractual arrangements
- Recoverability of deferred tax assets

For more guidance on the above topics, see the resources listed below:

- ICAEW publication Coronavirus (COVID-19): Considerations for Group Auditors
- Deloitte publication: IFRS in Focus, Accounting Considerations Related to Coronavirus Disease 2019
- KPMG publication First Notes: COVID 19: Potential impacts on financial reporting
- ICAEW Article Coronavirus, going concern and the auditor’s report.
- Ernst and Young Article IFRS accounting considerations of the COVID-19 outbreak
- KPMG quick guide on COVID 19
- PWC Publication: Considering the potential business impacts of the COVID-19 outbreak
- PWC publication: In depth A look at current financial reporting issues