FINANCIAL ACCOUNTING IMPLICATIONS OF THE COVID-19 OUTBREAK

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Introduction

While the outbreak of COVID-19 (Coronavirus) is primarily a public health issue the outbreak will have implications for both financial reporting and the work of the auditor. The information below seeks to set out the main financial reporting matters that preparers of financial statements should consider as a result of the coronavirus[1].

1. Events after the reporting period
2. Going concern
3. Impairments of non-financial assets
4. Provisions
5. Government grants

Events after the Reporting Period

In preparing financial statements management are required to consider all events up to the date on which the financial statements are authorised for issue. FRS 102 provides for two types of events after the end of the reporting period, adjusting and non-adjusting.

For companies reporting to 31 December 2019 the effects of the virus are likely to be considered a non-adjusting event, as the coronavirus was not discovered until January 2020 and therefore does not provide evidence of conditions that existed at the balance sheet date. However, where the effects of the virus are material Para 32.10 of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* requires disclosure of

a) The nature of the event; and
b) An estimate of its financial effect or a statement that such an estimate cannot be made

Where a company is reporting to 31 January 2020 or a later date the effects of the virus could be an adjusting or non-adjusting event.

Going concern

COVID-19 has caused a significant deterioration in economic conditions for many companies across a variety of sectors. Responsibility for preparation of financial statements rests with management and in preparing the financial statements management will need assess whether the business remains a going concern. The going concern basis is appropriate unless they either intend to liquidate the entity or cease trading or have no realistic alternative but to do so.[2]

Management assessment

Management are required in preparing financial statements to make an assessment of the entity's ability to continue as a going concern. In making this assessment, which should consider a period of twelve months from the date of approval of the financial statements, management will need to consider whether the entity remains a going concern and if so

[1] For an entity preparing its financial statements in accordance with FRS 102, The Financial Reporting Standard Applicable in the UK and Ireland.
[2] Para 3.8 FRS 102, The Financial Reporting Standard Applicable in the UK and Ireland

does any deterioration in the economic conditions result in material uncertainties casting significant doubt on the entity's ability to continue as a going concern.

This will likely require significant revision of existing budgets and forecasts for 2020 by management, which will have been prepared in 2019, to reflect the changing economic circumstances and to support their assessment. Where management conclude that the entity is no longer a going concern the financial statements will be required to be prepared on a basis other than going concern, for example the break-up basis.

Disclosure

If management conclude that the entity is a going concern, but material uncertainties exist related to the entity's ability to continue as a going concern, disclosure is required of those uncertainties[3]. Where an entity does not prepare its financial statements on a going concern basis, this fact together with the basis on which they have been prepared and the reason why the entity is not regarded as going concern must be disclosed.

Impairments

The impact of the COVID-19 outbreak has caused a significant deterioration in the economic environment in which many companies are operating, and this is potentially a triggering event requiring an impairment review.

FRS 102, Section 27 *Impairment of Assets* applies to a number of assets including

- tangible fixed assets;
- intangible assets and goodwill;
- stock;
- investment property measured at cost; and
- investment in associates and joint ventures.

At each reporting date an entity is required to assess whether there is any indication that an asset may be impaired, and if so estimate the recoverable amount of the asset[4]. In assessing whether or not there is an indication that an asset has been impaired the standard sets out examples of indicators which, at a minimum, should be considered including

- Significant changes with an adverse effect on the company have taken place during the period, or will take place in the near future, in the market or economic environment in which the company operates; and
- The carrying amount of the net assets of the company is more than the estimated fair value of the company as a whole.

Where the recoverable amount of the asset is less than the carrying amount, the asset should be reduced to the recoverable amount with an impairment loss generally being recognised immediately in the profit and loss account unless the asset is carried at a revalued amount. Recoverable amount is the higher of its fair value less costs to sell and its value in use[5]. The fluid nature of the COVID-19 outbreak will present challenges for companies in calculating recoverable amount, for example it will be difficult to estimate future cashflows for the

[3] Para 3.9 FRS 102, The Financial Reporting Standard Applicable in the UK and Ireland
[4] Para 27.7 FRS 102, The Financial Reporting Standard Applicable in the UK and Ireland
[5] Para 27.11 to 27.20A, The Financial Reporting Standard Applicable in the UK and Ireland

purpose of the value in use calculation given the uncertainty as to how long the crisis is likely to last.

Stock

Entities are required to assess at each balance sheet date whether items of stock are impaired[6]. The assessment is carried out by comparing the carrying amount of each item of stock with its selling price less costs to complete and sell. Practical difficulties may arise in relation to estimating selling price less costs to complete and sell as a result of falling demand potentially impacting sales prices and costs to complete and sell may change due to increases in the cost of materials or labour.

Basic Financial Instruments

Trade Receivables

Customers may not be able to pay amounts due in accordance with normal credit terms as a result of the coronavirus outbreak. Trade debtors would generally qualify as basic financial instruments in accordance with the conditions set out in Section 11, FRS 102 *Basic Financial Instruments.* Entities will be required to consider at the balance sheet date whether there is objective evidence that trade receivables are impaired and where this is the case an impairment loss should be recognised in the profit and loss account[7].

Provisions

The crisis is already adversely impacting many companies with declining sales, issues affecting production and disruption of supply chains resulting in closures of stores and other facilities. As a result, it may be necessary for entities to recognise additional provisions in relation to onerous contracts or contractual provisions imposing penalties for failure to failure to fulfil contractual obligations.

Section 21, FRS 102 *Provisions and Contingencies* requires entities to recognise a provision

a) Where it has an obligation at the balance sheet date resulting from a past event;
b) It is probable that a transfer of economic benefits will be required in settlement; and
c) The obligation can be estimated reliably

A provision is recognised as the best estimate of the amount required to settle the obligation at the balance sheet date. Where the time value of money is material, the amount of the provision should be discounted to present value using a pre-tax rate that reflects current market assessments of the time value of money.

Onerous Contracts

A contract may become onerous if costs associated with the contract rise, for example the disruption to supply chains as a result of the crisis may force companies to source alternative suppliers or labour costs may increase as a result of the need to hire additional staff. In

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[6] Para 27.2 FRS 102, The Financial Reporting Standard Applicable in the UK and Ireland
[7] Para 11.21 and 11.22, FRS 102 The Financial Reporting Standard Applicable in the UK and ROI

addition, benefits receivable under the contract may be expected to be lower as a result of declining demand impacting on pricing.

Entities will need to review existing contracts, including termination and force majeure clauses, to ascertain whether any existing contracts have become onerous. Where a contract has become onerous the present obligation under the contract should be recognised as a provision[8]

Restructuring

An entity only recognises a provision for restructuring costs where it has an obligation (legal or constructive) at the reporting date to carry out the restructuring[9].

Future Operating Losses

As there was no past obligating event an entity cannot recognise a provision in respect of future operating losses[10]

Government grants

In response to the COVID-19 crisis Governments around the world are introducing measures to support businesses and stimulate the economy. Where an entity has received government assistance and the assistance meets the definition of a government grant it will need to be accounted for in accordance with FRS 102, Section 24 *Government Grants*.

The glossary of FRS 102 defines a Government grant as "assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the operating activities of the entity". The term government includes government agencies and similar bodies whether local, national or international.

Government assistance provided in the form of benefits available in determining taxable profit or loss or are determined on the basis of income tax liability (for example tax holidays and reduced income tax rates) are specifically outside the scope of Section 24, FRS 102 Government Grants. Entities will therefore need to carefully consider the differing forms of government assistance that they may receive in order to determine the appropriate accounting treatment for that assistance. If an entity has not previously been in receipt of government grants new accounting policies will be required to be developed.

Government assistance, meeting the above definition, can be recognised using either the performance or accrual model where there is reasonable assurance that the entity will comply with the conditions attached to the grant and that the grant will be received.

FRS 102, Section 24 *Government Grants* requires disclosure of the following

a) The accounting policy adopted;
b) The nature and amount of grants recognised in the financial statements;
c) Unfulfilled conditions and other contingencies attaching to grants that have been recognised in income; and
d) An indication of other forms of government assistance from which the entity has directly benefitted, for example the provision of guarantees.

[8] Para 21.11A, FRS 102 The Financial Reporting Standard Applicable in the UK and ROI
[9] Para 21.11B, FRS 102 The Financial Reporting Standard Applicable in the UK and ROI
[10] Para 21.11B, FRS 102 The Financial Reporting Standard Applicable in the UK and ROI

Other considerations

- Breach of covenants – has the entity breached financial covenants given in respect of company borrowing require debt to be reclassified from long-term to short-term?
- Are employee benefits impacted such as defined benefit schemes and remuneration packages including termination?
- Have fair values recognised in the financial statements been appropriately determined?
- Are deferred tax assets recoverable?