The likely impact of Covid-19 on financial statements in the years ahead

by Colm Divilly

In the last two articles in this series we focused on the immediate impact of Covid-19 on company financial statements and the possible audit report options open to the auditor reporting in the context of Covid-19. In this article we will discuss the likely impact of Covid-19 on financial statements in the medium to long term.

To date, the economic impact of Covid-19 on the Irish economy has been cushioned by an unprecedented injection of exchequer funding into the economy. In the medium term, the inability of the government to continue borrowing vast sums of money at near zero interest will bring about a natural end to this source of economic stimulus. When the economic stimulus ends the economic impact of Covid-19 will become clear for Irish businesses and the Irish economy. This impact is likely to be a severe economic shock to the economy resulting in a serious but hopefully short recession. Many of the accounting and auditing challenges faced by the Irish accounting profession in the period of the last recession (2008 to 2013) are likely to reappear. We outline below how some of these issues will be accounted for using the FRS 102 financial framework.

Impairment of property plant and equipment ("PPE")

FRS 102 requires that PPE be impaired if the recoverable amount of an asset is less than the carrying amount, in which case the carrying value of the asset is reduced to the recoverable amount of the asset. That reduction is an impairment loss. The recoverable amount of the asset is the higher of the net realisable value of the asset and the value in use of the asset. An entity is required to assess at each reporting date whether there is any indication that an asset may be impaired. If any such indication exists, the entity must estimate the recoverable amount of the asset. If there is no indication of impairment, it is not necessary to estimate the recoverable amount. As the impact of Covid-19 on the economy becomes clearer, Accountants will need to be vigilant for indications of impairment of PPE and where identified undertake an impairment review.

Decrease in value of investment property

An investment property is measured at fair value at each reporting date with changes in fair value recognised in profit or loss. Therefore, the impairment of these assets will be picked up by the fair value adjustment at the end of each financial year. The triennial review of FRS 102 introduced a new accounting policy choice solely in relation to investment property rented to another group entity. Such entities are now allowed to choose to measure such properties at cost (less depreciation and impairment). If a group company has adopted this new accounting policy choice, the guidance provided above in relation to impairment of PPE will apply to that entity's investment property.

Material uncertainty in relation to the application of the going concern basis in the preparation of an entity's financial statements

FRS 102 requires that when preparing financial statements, management must assess the entity's ability to continue as a going concern. An entity continues to be a going concern unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue. If management is aware, in making its assessment, of material uncertainties related to events or conditions that cast significant doubt upon the entity's ability to continue as a going concern, the entity must disclose those uncertainties in the notes to the financial statements. When an entity does not prepare financial statements on a going concern basis, it must disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern".

If the economy suffers a severe economic shock, it is likely that material uncertainty in relation to the ability of entities to continue as a going concern will become a common issue faced by Accountants. In drafting disclosure notes in relation to uncertainty facing the entity, it should be noted that International Standard on Auditing (Ireland) 570 (ISA 570) requires that if the auditor of the entity concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor should determine whether the financial statements:

a. Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

b. Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor will be able to express an unmodified audit opinion but should address this matter in the audit report by way of a material uncertainty paragraph in the audit report.

Recognition of stock losses

Paragraphs 27.2 to 27.4 of FRS 102 require an entity to assess at the end of each reporting period whether any stocks are impaired. Impairment of stock is likely to arise from damage, obsolescence, or declining selling prices. If an item (or group of items) of stock is impaired, those paragraphs require the entity to measure the stock at its net realisable value and to recognise an impairment loss. Decreased customer demand in a recessionary environment is likely to lead to downward price pressure and stock surpluses giving rise to stock impairments.

Recovery of trade and other receivables

Unfortunately, in a recession the risk of bad debts increases significantly. At the end of each reporting period an entity is required to assess whether there is objective evidence of impairment of any financial assets measured at cost or amortised cost.

If there is objective evidence of impairment, an impairment loss is recognised immediately in profit or loss. Losses must be the result of past events, not losses expected because of possible future events. In the absence of any objective evidence or observable data indicating that a loss has occurred, there is no basis for recognising an impairment, or bad debt provision. It is important when drafting financial statements in the coming months that Accountants do not provide for expected future impairment losses but base any bad debts provisions on objective evidence of the occurrence of an event giving rise to the impairment.

Accounting for redundancy costs

Unfortunately, employee redundancy may become a common feature of the economy in the next year. FRS 102 requires that because termination benefits do not provide an entity with future economic benefits, an entity must recognise them as an expense in profit or loss immediately. An entity will recognise termination benefits as a liability and an expense only when the entity is demonstrably committed either:

a. to terminate the employment of an employee or group of employees before the normal retirement date; or

b. to provide termination benefits as a result of an offer made to encourage voluntary redundancy.

Accounting for future operating losses.

In the months ahead, Accountants may well find themselves preparing financial statements for a current financial period in the knowledge that the entity has incurred significant losses in the post balance sheet period. The question arises should these losses be provided for in the current financial period? FRS 102 answers this question by stating that as there is no present obligation as a result of a past obligating event (no obligating event at the balance sheet date requiring entity to pay out resources in the future), the entity does not recognise a provision for future operating losses. While the expectation of future operating losses may be an indicator that one or more assets are impaired, the future expected losses are not provided for in advance of being incurred.

Accounting for restructuring costs

Where the economic situation results in an entity having to restructure, FRS 102 provides valuable guidance on how and when to account for the restructuring cost.

A restructuring gives rise to a constructive obligation only when an entity:

a. has a detailed formal plan for the restructuring identifying at least:

   i. the business or part of a business concerned;

   ii. the principal locations affected;

   iii. the location, function, and approximate number of employees who will be compensated for terminating their services;

   iv. the expenditure that will be undertaken; and

   v. when the plan will be implemented; and

b. has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

The entity will only recognise a provision for restructuring costs when it has a legal or constructive obligation at the reporting date to carry out the restructuring.

Conclusion

This article was written just as the Government announced a return to level 5 restrictions within the economy. I hope that by the time you read this article, we as a Country will have turned the corner in our battle with the Covid-19 virus and that much of the guidance in this article will not be required.

In this period of worry and doubt we can remember the old Irish saying "Dá fhada an lá tagann an tráthnóna (No matter how long the day, the evening comes)" and know that it will apply to our current situation as well.

> **"Dá fhada an lá tagann an tráthnóna"**

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