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Impact of COVID-19 on Financial Reporting

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Introduction

The evolving coronavirus disease (COVID-19) pandemic has directly affected the global economies and the daily lives of every member of the global community.

In this article, we seek to highlight the impact of COVID-19 on financial reporting and enable Directors and those charged with governance (“TCWG”) to focus on key responses as they continue to discharge their financial reporting responsibilities.

The Effect on Financial Reporting

The business operations of almost all industries have been directly impacted by the travel restrictions and social distancing requirements. The extent of impact varies between industries, and government assistance has also been tailored to give more support to the industries most-severely affected. Business operations have also been significantly affected for many companies, including those heavily reliant on human resources from foreign countries and those with multi-location operations in more than one country, particularly in countries where the COVID-19 outbreak has been most widespread and severe.

The Accounting and Corporate Regulatory Authority (ACRA) has issued Financial Reporting Practice Guidance in relation to areas in financial statements that are affected by COVID-19. The Institute of Singapore Chartered Accountants (ISCA) has also issued Financial Reporting Bulletins (FRBs) to provide guidance on accounting treatment of several government assistance and Frequently Asked Questions (FAQs) relating to the impact of COVID-19.

We highlight certain commonly encountered considerations[1] of the Financial Reporting Standards in Singapore[2] (FRSs) as follows:

[1]Please note that we do not warrant to present a complete list of considerations in this document as it is impossible to do so since every entity would have its specific or peculiar circumstances. Please contact your usual client service partners or managers, and we would be pleased to discuss in greater detail with you.

[2]Listed entities may refer to the equivalent in Singapore Financial Reporting Standards (International).

- ## Basis of Preparation of Financial Statements

Going Concern (FRS 1 Presentation of Financial Statements and FRS 10 Events after the Reporting Period)

An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so. When making assessment on the ability of the entities to continue as a going concern, entities should take into account all available information about the future obtained after the reporting date and continuously update the assessment up to the date of authorisation of the financial statements. In assessing the impact, entities should consider:

- Impact of travel restrictions and social distancing requirements on operations and revenue generating activities
- Availability of government aids and assistance
- Existing financial resources including sources of financial support
- Financial health of key suppliers and customers
- Period over which the conditions continue or deteriorate

When entities conclude that going concern basis of accounting is appropriate, disclosures may be required to bring to the users' attention on the existence of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern and the judgment management made in arriving at the conclusion. Even when it is concluded that there is no material uncertainties relating to going concern assumption despite the adverse indicators, disclosures should be customised to include how the entities are affected and how the entities have been responding to the negative impact, including mitigating factors considered.

- ## Impact on Key Financial Statement Areas

- **Impairment of Non-Financial Assets (FRS 36 Impairment of Assets)**

  It is expected that the current economic conditions would most likely constitute an impairment indicator, and hence trigger impairment testing for a large class of assets. This is in addition to the annual impairment testing of goodwill and classes of intangible assets with indefinite useful lives. The impairment assessment cycle may be time consuming and especially challenging for entities that have not had a readily set up process in preparing detailed cash flows forecast and projection to arrive at a recoverable amount determined in accordance with the requirements of with the relevant FRS. Entities should also consider multiple-scenarios cash flows forecast to derive at a range of probability-weighted outcomes. This may be necessary as the effects of COVID-19 is wide spread and evolving and are dependent on many external factors outside the control of the entity's management.

  In making the assumptions, management should base their estimates on all available information, including information obtained after the reporting date which shed lights on the conditions existed as at reporting date (i.e. adjusting events in accordance with FRS 10). In estimating cash flows that forms a basis of value-in-use, it is reminded that the cash flows should exclude the effects of restructuring not yet committed as at reporting date and should include the expected government assistance based on publicly available information. As the process involves significant judgement, and cash flows may be sensitive to certain key assumptions, it takes careful deliberation amongst management team, directors and TCWG, with early engagement of auditors and experts, if necessary, in arriving at management's best estimate. When relevant and material, entities should include disclosure of the estimation uncertainty and sensitivity analysis of the key assumptions in the financial statements.

- **Impairment of Financial Assets - Expected Credit Losses ("ECL") (FRS 109 Financial Instruments)**

  ECL is a probability-weighted measure and need to take into account forecast of future economic conditions that is based on reasonable and supportable information which are reasonably available at the reporting date. For entities dealing with a wide customer base, disaggregating customers into sub-groups with shared credit risk characteristics such as industry and geographical location, will result in a more meaningful analysis of historical loss rate and forward-looking adjustments.

- **Fair Value Measurements (FRS 113)**

  Entities may need to determine fair value of its assets on recurring basis or consider fair value as a basis of recoverable amount in its impairment testing under FRS 36. Fair value measurement should reflect the market participants' expectations at the measurement date. Entities may need to engage experts in order to arrive at the fair value. ISCA has issued a Financial Reporting Guidance to introduce best practices when engaging valuers for real property valuation for financial reporting and has also issued a FAQ to highlight on the need to carefully assess the implication of any caveat relating to the estimation uncertainty included in valuation reports.

  Entities should take note of FRS 1 requirements to disclose assumptions it makes about the future and the estimation uncertainty at the reporting date with significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. This would be required unless the fair value is based on a quoted price in an active market for an identical asset or liability. As it is expected that the underlying financial and non-financial assumptions contain a higher level of volatility, disclosures should be customised to disclose the relevant valuation techniques, the non-observable inputs included and sensitivity analysis of those inputs, if material.

- **Determination of Net Realisable Value (FRS 2 Inventories)**

  Entities need to estimate the Net Realisable Value (NRV) of its inventories to assess if any write-down is necessary to reflect any decline in future estimated selling prices or higher costs to complete in the current economic environment. As the utilisation rate for manufacturing plants may be lower in 2020 due to disruptions in operations and lower market demand, adjustments may be required when performing allocation of overhead costs to inventories costing, as such allocations are based on the normal capacity of such facilities.

- **Provisions for Contingencies or Onerous Contracts (FRS 37 Provisions, Contingent Liabilities and Contingent Assets)**

  Entities need to consider the impact of difficult economic conditions on provisions, for example, in determining whether there is an onerous contract, or determining probability of the cash outflows. This may result in provisioning to be made on the balance sheet, or at least, a more extensive disclosure about the related judgement and estimation uncertainty.

- **Accounting for Effect of Government Assistance (FRS 20 Accounting for Government Grants and Disclosure of Government Assistance)**

  In order to help entities to cope with COVID-19, the government has announced various government assistance schemes, such as rental relief and cash grants for salary costs. Recognition of such grants should not be made on a cash (receipt) basis. Grants should be recognised when there is reasonable assurance that the entities qualify for the specified criteria and will receive the grant, which could be earlier than the receipt date. Entities should comply with FRS 20 and to make reference to the relevant FRBs published by ISCA, to ensure that these grants (income) are recognised in the appropriate period in which the related costs, for which it intended to compensate, are recognised as expenses.

- **Leases Contract Revisions or Rent Concession (FRS 116 Leases)**

  Entities are advised to early adopt the amendments to FRS 116 which allows the application of the practical expedient not to assess if eligible COVID-related rent concession are lease modifications, and to recognise those rent concessions as negative variable lease payments in profit or loss. The amendments are effective for annual period beginning on or after 1 June 2020. However, it allows early adoption for financial statements authorised for issue after 28 May 2020.

  Entities may negotiate for a revised contract to reduce the asset leased or shorten lease term in response to the economic condition and/or remote work arrangements. In this case, entities should calculate corresponding impact on reduction of Right-of-Use Asset, lease liabilities and recognise the partial termination gain or losses, before remeasuring these assets and liabilities based on revised discount rate which is likely to be lower post-COVID.

  Even when there is no revision of contractual terms, entities should revisit their previous assessment of lease term, when management has made strategic decisions within their control that affect the likelihood of exercising the extension or termination options.

- **Classification and Modifications of Financial Liabilities (FRS 1 and FRS 109 Financial Instruments)**

  As the challenging business environment may have an impact on liquidity and other financial indicators, it is critical for entities to assess the impact of non-compliance with loan covenants on the appropriateness of going concern assumption and classification of loan (between current and non-current liabilities). When waivers from banks are obtained after the financial reporting date, it should not affect classification at the reporting date, but the effect of which should be duly disclosed.

  When entities negotiated for a loan restructuring, entities should assess whether it represents substantial modification of terms, i.e. if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability. Substantial modification of financial liabilities are accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability, and recognise the difference (together with any cost or fees incurred) in profit or loss. For non-substantial modifications, entities should remeasure the liabilities at present value of revised cash flows discounted at the original effective interest rate after deducting any cost or fees incurred, and recognise the difference in profit or loss as modification gain or loss.

- **Recognition of Deferred Tax Assets (FRS 12 Income Taxes)**

  Entities may have recognised deferred tax assets on unused tax losses on the basis of expected future taxable profits. The amounts and availability of future tax profits may need to be adjusted in line with the current economic conditions. This may affect the recognition of deferred tax assets.

- **Revenue Recognition (FRS 115 Revenue from Contracts with Customers)**

  Depending on the type of goods or services provided, the fulfilment of performance obligations may have been affected by the government measures of lock-down, or entities may enter into price concession arrangements, provide extended payment terms or extension of availability of loyalty points or similar arrangements, or offer additional goods or services at a discount to the customers. Entities will need to assess the corresponding impact on revenue recognition.

  FRS 115 requires entities to estimate variable consideration or defer certain portion of receipts to refund liabilities when appropriate. When making such estimation, entities are reminded to take into account the economic conditions and expectations as at the reporting date. FRS 115 contains specific guidance on contract modifications, including the scope or price reduction which should be accounted for as a new contract if the remaining goods or services are distinct from the goods or services transferred, or calculate cumulative catch-up adjustments if otherwise.

- **Restructuring Plans and Effect (FRS 37, FRS 19 Employee Benefits and FRS 105 Non-Current Assets Held for Sale and Discontinued Operations)**

  When entities plan for restructuring in response to the changes in business plans, questions may arise as to the timing of recognition for restructuring costs, and in certain instances, including employee termination costs. Entities need to consider the requirements in FRS 37 with respect to whether or not the entities have a constructive obligation at the reporting date to restructure and hence, need to provide for such costs, i.e. when the entity has a detailed formal plan for the restructuring and 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. If restructuring involves payment of termination benefits to employees, liability should be recognised at the earlier of when the entities can no longer withdraw the offer of those benefits and when restructuring costs is recognised, in compliance with FRS 19.

  In addition, if the restructuring involves the disposal of a group of non-current assets (‘disposal group’), entities should consider if it fulfils the criteria of non-current assets held for sale in FRS 105, which affect the measurement and classifications of those disposal groups on the balance sheet, and if it represents a separate major line of business or geographical area of operations which require presentation of profit or loss from discontinued operations in profit or loss separately from continuing operations.

- **Disclosure of Risks Arising from Financial Instruments (FRS 107 Financial Instruments: Disclosure)**

  In view of the current economic conditions, entities should consider making extensive disclosure on how they are managing market risks, liquidity risks and credit risks. For example, entities may consider the disclosure of sensitivity analysis of equity price risks or interest rate risks based on the extent of subsequent fluctuations of the index or interest rates.

Concluding Remarks

As the extent and nature of the impact of COVID-19 on financial reporting varies from entities to entities, management is advised to assess based on the specific circumstances relevant to the entities and include qualitative disclosures that are customised to the pertinent risk factors.

Directors and TCWG can expect significant challenges in finalising the audited financial statements and the accompanying auditors' report. Early engagement with auditors, along with continuous and timely discussion, is therefore strongly recommended.

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