



COVID-19 impact: the due diligence perspective

Transaction services

April 2020



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Foreword

The rapid outbreak of the coronavirus (COVID-19) presents an alarming health crisis that the world is grappling with. The outbreak has been declared as a pandemic by the World Health Organisation (WHO) and a notified disaster by the Government of India. Measures to combat the pandemic have resulted in significant disruptions in business operations coupled with trade restrictions and non-fulfilment of contractual obligations. These are expected to cause consequential deterioration in economic conditions for some companies and an increase in economic uncertainty for others across almost all sectors. Together, these may have unusual accounting, audit and reporting implications for the companies for the financial year ended 31 March 2020 and beyond.

The COVID-19 outbreak is also expected to create a number of potential challenges for companies and investors. Possible situations that could arise due to the outbreak could include - management does not conduct an inventory count on the balance sheet date, obtaining timely confirmations from customers, assessing

value of unsold inventory, potential of sales returns, recovery of dues/loans, impact of exchange rate changes and a host of other issues. Accordingly, the ongoing disruption will impact cashflows, working capital and earnings. As part of any due diligence process, going forward, buyers will need to focus on short term cash flow impact and commercial diligence to understand the impact on supply chain, market share and technology in changing business models. As this disruption will create significant uncertainty around earnings potential, business projections by sellers will need to be robust and deal structures with earnout options may tend to be preferred.

Through this deck, we aim to highlight some of the focus areas in your financial and tax due diligence process given the current COVID-19 situation and also bring out some sector specific issues which need to be considered during the diligence phase. This is not meant to be an exhaustive list of procedures but only indicative and these will be tailored to specific situations as the case maybe.

Diligence approach to consider to reflect new realities and economic disruption

Financial statements and reporting



- **Financial reporting** impact will vary depending on the degree of exposure of the company's operations to the COVID-19 outbreak, key areas impacted include (a) going concern assessment (b) re-assessment of accounting estimates and fair value measurement (c) revenue recognition (d) contract renegotiations amid invoking of force majeure clauses and (e) additional disclosures
- **Completion of audit and auditor's report:** Companies may face challenges in supporting audit process and provide audit evidence

- **Cash flows:** Significant stress on cash flows and headway available with the companies subject to temporary relief in form of moratoriums.

There have been specific guidelines issued by the ICAI for financial reporting (please click link below to download KPMG in India's point of view document on this topic)



Revenue and margins



- **Revenue recognition aspects** such as estimate of variable consideration and timing of revenue recognition including assessment of collectability of consideration
- **Revenue and margin loss assessment** due to (a) closure of business activities, (b) decrease in customer demand and (c) customer loss. Management assumptions and computation of impact on historical and forecast business performance will need to be closely analysed for FY21, FY22 and FY23 with appropriate sensitivities

- **Fluctuation in currency exchange rates, commodity prices and crude oil:** Assess one-time and recurring impact of significant fluctuation in currency exchange rates, commodity prices and crude oil prices and underlying hedging on business performance
- Detailed analysis and substantive procedures over revenue cut-off testing, testing of receivables, impact on sales returns and volume/rate discounts.

Employee cost

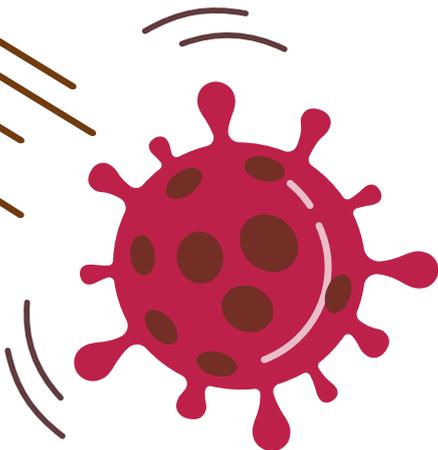


- **Employee layoffs:** COVID-19 may result in significant employee retrenchment, suspension of pay, impact of technology on current business model, change in remuneration policies and severance pay expenditure. Further, run rate adjustment where salaries have not been paid or provided for any period due to COVID-19 will need to be considered
- **Employee benefits:** Assumptions for actuarial valuation of employee benefit liabilities including gratuity, leave encashment and Employee stock ownership plans (ESOPs) will need to be reviewed
- **Increments and unpaid bonuses:** Increments and bonuses for FY20 v/s past years to be analysed
- **Labour cost impact and productivity** to be assessed in light of shortage in supply of migrated labour.

Other direct and indirect overheads



- **Rental cost** may be renegotiated by invoking force majeure clause and there will be a need to assess revised agreements and potential disputes/ disagreements. Impact on rental costs due to fixed minimum payout instead of revenue share particularly in retail and restaurants sector to be analysed
- **Freight costs:** Transportation and freights costs may increase substantially in short term due to higher demand and supply chain disruptions
- **Selling, general and administrative cost absorption** on account of closure of business activities and inefficiencies in operations will need to be assessed
- **One-time expenses** on account of COVID-19 including technology upgradation and other costs incurred to enable remote working to be quantified
- **Reduction in discretionary spend:** Need to analyse impact of reduction in discretionary spends such as advertisement, travel and recruitment.



Cash flow and working capital



- **Working capital and cash requirements** may be impacted significantly on account of disruption in revenue and payments cycle and business requirement to preserve cash. Hence, will require deep dive into monthly / quarterly working capital and cashflow trends (historical and future). Will be critical to identify one-time items to assess normalised working capital levels of the business and determine target working capital for purposes of closing adjustments
- **Debtors:** Detailed analysis of collections and critically assess adequate provision for doubtful receivables or additional discounts passed to customers. Perform additional substantive procedures including (a) obtain balance confirmations (b) revenue to cash reconciliations and (c) detailed testing of subsequent collection
- **Inventory** valuation impacted by reduced movement in inventory, decline in selling prices, allocation of normal overheads and inventory obsolescence due to lower than expected sales to be assessed. Alternate procedures required to perform inventory count impacted by lockdown at financial year end
- **Trade creditors and current liabilities:** With disruption in payment cycles, there will be a need to assess level of overdue payables and potential disputes
- **Contingencies:** Due to COVID-19, need to exercise judgement in making provisions for onerous contracts and short-term operational disruptions
- **Fair value measurement** for financial assets to be assessed including assumptions such as interest rate and management projections.

Debts and covenants



- **Terms of borrowing:** Analyse relief provided by banks/renegotiation of terms for rescheduling and moratorium on repayments
- **Financial and other covenants:** Assess breach of financial and other covenants and implications on business
- **Capitalisation of borrowing cost** may get deferred as asset development is suspended, it may put further strain on profitability.

Property, plant and equipment (PPE) including intangibles



- **Impairment of intangibles including goodwill** to be re-assessed with contraction in economic activity. Recoverable amount should be closely analysed for assumptions relating to discount rates, forecast profit and loss account and cash flows
- **Estimated useful life and residual value of PPE:** On account of lockdown and plant closure, property plant and equipment (PPE) may remain idle and expected useful life and residual life shall be re-assessed.
- **Projected capex:** Analyse projected capex for capacity expansion and maintenance

Other matters



- **Onerous contracts:** Assess potential onerous contracts i.e. contracts where costs of meeting the obligations exceed economic benefits expected and analyse its impact on business profitability.
- **Related party investments and balances:** Critically analyse related party transactions, potential conflict of interest and assess impairment or provision required
- **Penalty or liquidated damages implications:** In case of projects business or long-term contracts, need to analyse trigger of penalty or liquidated damages due to delays in execution amid lockdown
- **Income taxes:** Recovery of deferred tax assets based on re-assessed forecast profits by management to be critically analysed.
- **Taxes:** Review computation of tax liability, assess compliance with tax regulations and potential default in tax filings.
- **Leases:** Companies may need to assess its right-to-use assets for impairment. In addition, accounting for lease contracts and revenue recognition by lessor to be re-assessed.



Sector-specific deal considerations

Consumer markets

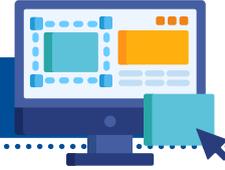


- **Sales channels/products:** Disruption in sales channels could lead to mismatch in demand and supply and buildup of channel inventories. Returns may also see a significant spike. Personal hygiene and FMCG products (higher consumption due to lock down) to witness a surge in demand
- **Raw material sourcing:** Significant challenges with (a) disrupted supply chains (b) import restraints from China and other impacted regions and (c) adverse forex impact
- **Perishable commodities:** Impact of near expiry items in the inventory could be inflated
- **Go to market:** Dependence on online channels may increase and hence margin structures need to be re-evaluated
- **Lease and other contract renegotiations:** Retailers and customers may renegotiate contracts invoking force majeure clause.



E-commerce

- **Demand:** Temporary decline in discretionary demand due to lockdown led by supply restrictions and reduced spending led by global slowdown. However, steady surge in e-commerce businesses is expected post lockdown due to shift in consumer behavior. Digital delivery of services (education, health and fitness and fintech) could see an upswing
- **Supply:** Logistical constraints led by lockdown have disrupted operations due to slowdown in manufacturing, restricted transportation and non-availability of delivery personnel. Employees displaced in other sectors could be used to meet increased manpower requirements (including expanding delivery capacity)
- **Technology:** Increased deployment of technology such as Internet of things (IoT) and Artificial intelligence (AI) could be used to drive efficiencies in managing supply chains, demand forecasting, payments and fulfilment.



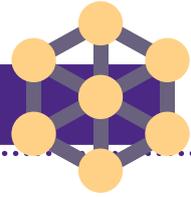
Technology services

- **Demand:** Clients are expected to reduce discretionary spends, although spends are expected to increase in sectors such as healthcare and telecom. Cost reduction initiatives could propel increased focus on offshore delivery. Pricing could come under pressure
- **Employees:** Attrition and new hiring is expected to reduce significantly. Wage increases and incentive payouts expected to may be minimal. Remote working could increase in prominence post crisis
- **Margins:** Reduced utilisation and pricing pressure could negatively impact margins in the short term, offset by favourable currency fluctuation, reduced attrition, minimal wage increases and reduction in overhead spends
- **M&A/Partnerships:** Muted valuations and reduced competition for assets (especially in digital services, outsourced R&D and engineering) could present attractive M&A opportunities for buyers with strong balance sheets. Divestment of non-core assets by global businesses could lead to availability of captives for sale.



Industrial markets and automotive industry

- **Demand:** Cement, metals and auto sector were already facing weak demand; demand in these sectors and other industrial markets may continue to be muted with global slowdown, declining market sentiment and purchasing power. In automobile, BSVI transition to lead to demand shocks for 2W and 4W in the near term
- **Raw material sourcing:** May get impacted by disruptions in supply chain of raw material with restriction on imports and fluctuations in material prices. In Auto, move to BSVI regime may further impact supply chain and value of inventory on books
- **Production and labour force:** Plant shutdown amid lockdown and decline in demand to result in layoffs/suspension of pay. High labour intensive sectors may face hit in operations amid lockdown and lead to tougher wage negotiations
- **Margins:** Exchange rate, crude oil and commodity price fluctuations to impact margins. Export oriented companies stand to gain in the short term
- **Capex:** Industrial markets, auto and other sectors may defer capital expansion plans in light of the uncertain demand situation in FY21. While certain companies could also consider increase in automation as a counter to risks associated with plant shutdowns.



Healthcare and pharmaceuticals

- **Demand:** Pharmaceuticals may witness surge in demand led by higher export of essential medicines, general public awareness and increase in funding and investments
- **Raw material sourcing:** Significant challenges with import restrictions from China/other regions, supply shortages and escalation in pricing, disruption in supply chains and an adverse impact of forex
- **Production and labour force:** Non availability of labour, deficient supply of material and physical distancing has bottlenecked volumes; Increased focus on production of medical equipment and ancillary consumables expected
- **Delivery:** Healthcare delivery likely to be impacted with lower patient footfalls and elective treatments.



Financial services

- **Credit stress:** Banking and lending entities may witness a reduction in demand in housing, consumer goods and business loans impacting (a) fee incomes; (b) inability to absorb fixed costs in light of reduction in new business; and (c) stress on liquidity and asset liability timings
- **Credit stress:** May witness increase in credit cost on account of stress on collections; especially for short tenure products where the ability to repay installment would be a challenge amid the slowdown in the economy and exposures to certain affected sectors like auto, real estate and travel and hospitality
- **Insurance sector:** Amidst the current crisis, insurance sector may witness an upside with potential increase in volumes on account of increased awareness and demand drivers
- **Capital markets:** Capital market linked businesses including wealth management, mutual funds and broking may witness a reduction in volumes but can expect a quick turnaround as recovery begins
- **Non-Banking Finance Company (NBFCs) solvency:** NBFCs to face significant challenge on liquidity and for certain NBFCs solvency may be a challenge
- **Operational restructuring:** Corporates, banks and Institutions may go for cost optimisation measures resulting in changing their operating model as well
- **Digitisation:** Digital transformation may pick-up especially in areas of collections, distribution, claims processing, etc.

Real estate



- **Revenue:** Potential renegotiation of rental terms for commercial assets/ malls, especially if flat revenue-sharing model is adopted by mall-operators may lead to decline in revenue streams and cash flows
- **Margins:** Likely increase in cost to complete due to disruptions in supply chain and limited ability of the developers to pass on the increased cost to the buyers in current scenario
- **Cash flows:** Liquidity strain caused by delay in project deliveries owing to supply disruptions, lower new residential demands and deferment of plans for new project launches; thereby adversely impacting the working capital and debt repayment capacity
- **Regulatory guidelines:** Increased risk of non-compliance of regulatory guidelines (example Real Estate (Regulation and Development) Act, 2016 or RERA), unless policy relaxation measures are announced by the regulator, may lead to financial penalties.



Infrastructure, transport and logistics

- **Revenue, costs and operations:** (a) impact of overall reduction in energy demand amid lockdown (b) disruption in operations and maintenance activity amid lockdown may impact the machine availability and could potentially lead to loss of generation of power (c) impact of reduction in bank rates on the annuity receipt of under-construction road projects (nearing completion) awarded under Hybrid Annuity Model (HAM) would need to be assessed; In logistics, demand to be adversely especially for 3PL players catering to the auto and IM sectors. While e-commerce focused logistics player likely to benefit from increased demand and higher adoption of online purchases
- **Working capital:** (a) delay in collection of receivables (b) payment delays to Operation and maintenance (O&M) vendors (including contract workers)
- **Project costs (under-construction) and financing:** (a) disruption in supply chain of key components sourced from China would lead to delay in project execution and could potentially increase project costs for under-construction/under-development projects; (b) potential delay in financial closure of the under-development projects; (c) potential breach of financial covenants under financing agreements and relaxation provided by the lenders (including bond holders).

How can KPMG in India's advisory services help?

CFO and Treasury

Capital structure optimisation

- Appraise the current capital structure, cost of debt, arrangements with banks and optimise the same for preserving value.

Cash management

- Assist in determining the level of liquidity and crisis cash needs, as well as tactical working capital actions that will optimise cash flow for the business.

IT advisory

Cyber risks and digitisation

- Assist in complete digital transformation with a strong value lens.
- We have developed a solution offering comprising of a toolkit which defines the baseline security controls specific to the operating model being adopted to enable work from home.

Tax advisory

Tax management

- We also have our tax specialists who can assist in (a) planning for losses, funding and impairments, (b) taking advantage of extended deadlines, (c) expanded scope of equalisation levy for non-resident e-commerce operators and manage CSR related tax matters.

Insight Sales

- Assist with full stack Insight Sales solutions and generate qualified leads.

Alternate Channels

Alliances

- Partnership with tech players for tech enabled distribution networks (order management), with logistics players to ensure uninterrupted supply of goods (order fulfilment), with eB2B platforms to increase direct coverage to fringe outlets.
- We also assist in exploring other alternate channels or alliances to improve revenues.

Cost and Supply chain

Supply chain maximisation

- Test for supply chain readiness; help prepare for day-zero (post opening).
- Assessments to make the supply chain more resilient.

Cost management

- Enterprise wide cost reduction to drastically reduce fixed costs or improve operating margin.
- Process improvement and efficiency through Lean Six Sigma tools, Agile.
- Managed services to reduce cost.

Customer and employees' sentiment

- Run diagnostics to understand how demand patterns will be impacted by customer and end market and prepare the revised go-to market plans.
- Engagement programs for employees to ensure productivity.
- KPMG Academy offers ready e-learning programmes which can help in upskilling the workforce.

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