Chapter 1

Interim financial reporting in light of COVID-19

This article aims to:

Discuss the key financial reporting considerations for the companies while preparing their interim financial results during COVID-19.

Introduction

Interim financial reports typically focus on changes since the last annual financial statements. However, preparing interim financial statements for the year 2020 is likely to involve more than the usual update since the last annual financial statements. This would warrant additional disclosures around the risks and uncertainties to which companies are exposed to, revisions in budgets and forecasts, changes in estimations or change in accounting policies and many other things alike.

In India, COVID-19 outbreak occurred towards the end of March 2020 i.e. near the year-end reporting for majority of the companies in India. Majority of the period of lockdown happened in the quarter ended 30 June 2020. Though the financial reporting impact areas as at 31 March 2020 are expected to remain relevant in the subsequent periods too, companies should re-evaluate the impact on interim results in light of evolving situation such as unlocking of the economy. Therefore, there is a need to provide updated information in the interim financial results that would be useful to various stakeholders including investors to adequately reflect the current and expected impact of the COVID-19 situation on the financial position, performance and cash-flows of companies.

In this article, we aim to highlight the key focus areas for companies while preparing their first interim financial reports for financial year 2020-2021. These may not be exhaustive and would depend upon a company's specific facts and circumstances and the industry in which it operates.

Interim financial reporting considerations

The areas that will require key focus are as following:

1 Going concern

While preparing the interim financial statements, it is crucial for companies to revisit and update their assumptions around going concern assessment made at the year-end.

2 Impairment of non-financial assets

Companies may have tested the assets for the impairment at the year end, however, given the evolving COVID-19 situation, there might be a need to test those assets for impairment during interim periods as well.

3 Fair value measurement

Fair valuation model of assets and liabilities that uses unobservable inputs would pose a challenge in the current environment. Also, given the current market volatility, extrapolations based on the balance at the previous annual reporting date may not be appropriate. Companies might need to consider using external valuers to determine the fair value of assets for which quoted prices are not available.

4 Revenue recognition

Due to the disruptions caused by the pandemic, determining whether rights and obligations under a contract are enforceable may require significant judgement and regular reassessment. As circumstances continue to change, companies should monitor the enforceability of their contract terms closely.

5 Expected credit loss

Assess whether existing contracts have been modified and account for these modifications when they are approved. Due to the pandemic, customers might be facing financial difficulties affecting their liquidity which might affect recoverability of the amounts due. Accordingly, companies would need to assess the related trade receivables and/or contract assets for impairment.

If a company recognises a material impairment loss on financial assets, then it provides in its interim financial statements an explanation of and an update to the relevant information included in the last annual financial statements.

6 Lease accounting

On account of COVID-19, many lessors are expected to provide rent concessions to lessees which could be in the form of rent holidays, rent reductions or waivers. However, it would be difficult for a lessee to assess whether a potentially large volume of COVID-19-related rent concessions are lease modifications. Consequently, the accounting can be complex i.e. the lessee may be required to recalculate lease assets and liabilities using a revised discount rate.

To address the challenge, recently, the Ministry of Corporate Affairs (MCA) has issued an amendment[1] to Ind AS 116, *Leases* and allowed lessees, as a practical expedient, not to assess whether rent concessions that occur as a direct consequence of COVID-19 pandemic and meet specified conditions as lease modifications and, instead, to account for those rent concessions as if they were not lease modifications. The amendment does not affect lessors. Lessors are required to continue to assess if the rent concessions are lease modifications and account for them accordingly.

Additionally, companies should evaluate other changes relating to a lease arrangement during the interim period which might potentially have financial reporting implications. For instance, change in lease term, change in lessee's incremental borrowing rate, termination of lease, etc.

1. A lessee should apply the amendment for annual reporting periods beginning on or after 1 April 2020. In case a lessee has not yet approved the financial statements for issue before the issuance of the amendment, then the same may be applied for annual reporting periods beginning on or after 1 April 2019.

7 Inventories

The outbreak may have an effect on the estimation of Net Realisable Value (NRV) used to measure inventories as at the reporting date. In case a company writes inventory down to its NRV at the interim reporting date, then any resulting losses need to be recognised immediately i.e. they cannot be deferred because they are expected to be restored or absorbed by the annual reporting date.

Adequate disclosures about judgements, revised estimates and write-down of any inventories to NRV or reversals should be provided.

8 Unusual items

A company discloses the nature and amount of items affecting assets, liabilities, equity, net income or cash flows that are unusual because of their nature, size or incidence.

9 Subsequent events

Companies should focus to identify events occurring after the end of the interim reporting period that may have a significant impact on the financial statements. Judgement would be required to determine whether the impact of these identified events need to be reflected through an adjustment to the financial statements (adjusting event) or by way of disclosures (non-adjusting event) as at the interim reporting date.

10 Disclosures

Specific disclosures that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period should be provided. These would, *inter alia*, include disclosure of:

- Changes in significant judgements and assumptions as well as areas of estimation uncertainty
- Disclosures of the impact of the COVID-19 outbreak on the interim financial position, performance and cash flows
- Any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period
- Transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments
- Changes in the classification of financial assets as a result of a change in the purpose or use of those assets
- Reversals of any provisions
- Changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities.

Next steps

- Given the continuous evolving economic situation in current times, it is imperative for management to take into consideration all relevant information up to the date of the interim financial results.
- Assumptions and judgements used by the management should reflect the conditions as of the measurement date and should be based on thorough understanding of the company's specific facts and circumstances. Adequate documentation of the judgements and assumptions should be maintained at all times as it will help management to re-evaluate them in the next reporting period.
- Audit committees also have an important role to play in monitoring management's response to the new events and risks on account of COVID-19. Particular attention to be paid in case of any change in methods, assumptions and judgements used while preparing financial results for the interim period.
- Regular and robust communication with auditors will enable early identification of potential issues with impact on interim financial results.
- Adequate disclosures on identified areas of risks, their impact on financial statements and the manner in which they have been addressed by the management would enable users of financial statements to better understand the impact of COVID-19 situation on the company's business operations, performance and cash flows.

  Recently, the Securities and Exchange Board of India (SEBI) has issued an advisory and encouraged listed companies to evaluate the impact of the COVID-19 pandemic on their business, performance and financial results, both qualitatively and quantitatively, to the extent possible and disseminate the same. It also provides an illustrative list of information that listed companies may consider while disclosing the impact of COVID-19. Those, *inter alia,* includes:

  – Estimation of the future impact of COVID-19 on its operations

  – Schedule, if any, for restarting the operations

  – Steps taken to ensure smooth functioning of operations.
- Internationally, the European Securities and Markets Authority (ESMA) has issued a statement on *'Implications of the COVID-19 outbreak on the half-yearly financial reports'*. The statement seeks to promote transparency and consistent application of European requirements for the

information provided in the half-yearly reports under the current circumstances related to the COVID-19 outbreak. With the statement, ESMA has encouraged issuers to update the assessment made at year-end about the assumptions regarding the future and other major sources of estimation uncertainty. Some of the other areas highlighted from interim reporting perspective are as follows:

- While assessing going concern, issuers are expected to consider all available information about the future, including the expected profitability and any restrictions to readily access financial resources.
- Identify events and transactions that may have triggered financial risks which were in full or in part unknown or not relevant at the end of the last annual reporting period such as debt renegotiations, new financial arrangements and breach of debt covenants. Disclose the exposures of issuers to credit, liquidity and other risks and the related sensitivities in accordance with requirements of IFRS 7, *Financial Instruments: Disclosures.*
- Disclose information relating to the significant impacts of the COVID-19 outbreak as part of the explanations of the amounts presented and recognised in the statement of profit or loss in a single note as part of the notes to the financial statements.

Similarly, U.S. Securities and Exchange Commission (SEC) has issued a guidance on COVID-19 related disclosures to be considered by companies. As per SEC, depending on a company's particular circumstances, it should consider whether it may need to revisit, refresh, or update previous disclosure to the extent that the information becomes materially inaccurate.

(Source: 'What is the impact of COVID-19 on interim financial statements?' by KPMG IFRG Limited dated 31 March 2020, ESMA statement on 'Implications of the COVID-19 outbreak on the half-yearly financial reports' dated 20 May 2020 and SEC guidance on COVID-19 dated 25 March 2020)