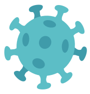
BANGOR BUSINESS SCHOOL



COVID-19 and financial reporting

As the pandemic continues, global economic and financial market uncertainty will significantly impact financial reporting. Professor Aziz Jaafar explores the situation.

The pandemic has adversely disrupted commercial activities. Many businesses have experienced a substantial reduction in earnings due to the closure of stores, sanctions on non-essential activities, declines in and revenues, volatility in the financial instruments, and the inability to raise capital.

Management should consider the consequences of these factors on how accounting items should be recognised, measured and disclosed. To do so, they must study relevant material assumptions and uncertainties affecting the operating results, strategies and risks.

Due to the pandemic, professional standard-setting bodies, prudential and securities regulators and accounting firms have issued guidance on financial reporting. In principle, disclosure and transparency of financial information are fundamental criteria, especially during heightened uncertainty such as COVID-19. Various aspects of financial reporting are potentially affected, but the main areas include going concern, financial instruments and impairment of assets.

Going concern

Going concern is probably the most critical consideration in financial reporting, especially during COVID-19. Financial statements are drawn on the basis that the company is assumed to operate in the foreseeable future unless the intention is to liquidate the business operation, cease trading or it has no realistic option but to do so. The International Accounting Standards 1 (IAS1) requires the management to evaluate the business' going concern, i.e., minimum of the first 12 months after the financial reporting date. Significant uncertainties arising from the pandemic about the business capacity to continue as a going concern can harm its strategic plan and ability to (i) raise capital at reasonable rates, (ii) meet debt covenants and other commitments, and (iii) secure supplier contracts as they may doubt the business' ability to fulfil its obligations.

Given that the pandemic has adversely disrupted business activities, the crucial question is whether COVID-19 creates substantial uncertainties around the business' ability to continue as a going concern. In doing so, management should consider wide-ranging factors that potentially affected its expected cash flows, earnings and solvency position, such as changes in general economic conditions, limited ability to operate, and decreased demands and revenue. Further, liquidity and solvency risk assessment are key components of the business' ability to operate as a going concern. Therefore, management should disclose the going concern assessment by providing sufficiently in-depth quantitative and qualitative information and disclosures about the cash flows, financing position and any potential changes to the current arrangements.

Financial instruments

Accounting for financial instruments is another area potentially affected by the pandemic, and one of the key items is the estimation of expected credit losses (ECL) allowance. Businesses are likely to be affected by significant drops in debts paid due to borrowers' facing cash flow constraints. Financial institutions are also being asked to assist borrowers by providing relief on cash-flow obligations. Reductions in economic growth forecast increase the likelihood of default across many borrowers.

Companies need to assess ECL that will be incurred on their borrowers and reflect credit loss allowances for increases in estimated non-recoverability of receivable amount. Under International Financial Reporting Standards (IFRS) 9 Financial Instruments, management should estimate ECL in a way that reflects a reasonable amount that is determined by assessing several probable outcomes. It is imperative that management provides adequate disclosures on the decision made and main assumptions used in calculating ECL, and the potential impact of any relief measures.

Key takeaways:

- *Disclosure and transparency of relevant financial information are fundamental criteria, especially during the current pandemic.*
- *The crucial question is whether COVID-19 creates substantial uncertainties around the business' ability to continue as a going concern.*
- *Although governments have implemented measures to assist affected businesses, the impact of COVID-19 on the global financial markets is expected to continue in the foreseeable future.*

The volatility of prices across various financial instruments due to increased market fluctuation, credit risk, and a decrease in market liquidity has also amplified during the current pandemic, affecting the fair value measurement. Applying IFRS 13 Fair Value Measurement, management should recognise financial instruments to reflect market-based data and participant views during the current market conditions. Since fair value measurement depends on assumptions and market inputs, any period of disruption presents challenges for management in ensuring that the fair value measurements reasonably reflect underlying market conditions. In particular, management should focus on the valuation of financial instruments based on unobservable inputs (i.e., Level 3 hierarchy) and ensure that the inputs are used appropriately to reflect the impact of COVID-19 in the projections of relevant cash flows.

Impairment of assets

Impairment of assets is another essential consideration for management during the pandemic regardless of the sector of operations. More attention should be focused on those entities with substantial assets including property, plant and equipment, inventories, and intangibles. Applying IAS 36, an asset is considered impaired when a business is not able to recover its carrying value, either by using it or selling it.

Some of the impairment indicators associated with COVID-19 include (i) the closure of stores, (ii) operational disruptions (iii) reduced demand and (iv) a decline in financial asset values. At the reporting date, management is required to assess whether the pandemic prompts an impairment test. In doing so, they should appraise the impact on the impairment estimations, including re-estimations to projected future cash flows and other main assumptions, such as useful life of the assets, growth rates and discount factor.

Other potential financial reporting items that may be affected by the pandemic include revenue recognition, inventory valuation, share-based payments, derivative and hedging considerations, insurance claims, government grants and assistance, and tax considerations.

Although governments have implemented various measures to assist affected sectors and businesses, the impact of COVID-19 on the global financial markets and economy is expected to continue to evolve in the foreseeable future. Consequently, management should constantly assess key financial reporting issues discussed above as circumstances change. In doing so, transparency and disclosure are vital in communicating relevant and reliable financial information to stakeholders. CB