COVID-19: Audit committee financial reporting guidebook

April 22, 2020

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The World Health Organisation declared Corona Virus (COVID-19) to be a public health emergency on January 30, 2020. Currently, whole of Pakistan is in some state of lock down and various measures have been taken by the Federal and Provincial governments including restricting the flight operations at the airports, curtailing intercity movements through buses and trains, temporary closing of businesses, schools etc. Given the current business and market conditions amid the growing pandemic, entities are likely to be faced with many accounting and reporting challenges depending on where they are in the fiscal year. These challenges come in the form of practical considerations, like the ability of an entity to "close its books," apply complex and judgment - based accounting concepts (arising as a result of current scenario), meet regulatory expectations and filing deadlines and address investor concerns.

While the board audit committees are facing this set of new challenges related to COVID-19, they must also continue to focus on and address their core responsibilities and reporting of any material issues to the board. In these uncertain times, entities will want to ensure that shortcuts are not being taken and rigor in procedures is still present. For example, if people are working from home then there should be proper protocol for reporting and executing things in order to be sure that systems / controls are not compromised. It is important for the audit committee to set the tone and ensure management is encouraging employees to ask for more time or additional resources in order to make sure things are done the right way.

The board audit committees need to make sure that they are working closely with their internal and external auditors. These are two resources that the audit committee can leverage in their oversight responsibilities. As far as it relates to internal audit, the priorities might have changed due to COVID-19. However, the board audit committee should understand what these delays and deferrals are and be comfortable that internal audit is addressing the appropriate areas of risk.

In light of this rapidly evolving environment, board audit committees will want to consider the following financial reporting considerations as they exercise their critical oversight role.

Financial reporting

Deadlines for Interim Financial Statements for the first quarter ended March 31, 2020

As business continuity challenges escalate, entities may experience issues with "closing their books" on a timely basis. The State Bank of Pakistan in the case of banks and other financial institutions coming under its regime has extended the timeline for filing of first quarterly financial statements by one month to May 31, 2020. On the other hand, the Securities and Exchange Commission of Pakistan (SECP) has notified that it will facilitate granting of extension in timelines for filing of first quarter financial statements based on applications sent by the companies to SECP.

The Board Audit Committees should be aware of potential workforce issues and the entity's ability to meet original or modified reporting deadlines. A system of controls can be rendered ineffective by people being unavailable or unable to meet responsibilities on which the system relies, or failing to adapt controls to changes in the business environment and how those controls are performed remotely. Ensuring that internal controls are still functioning effectively should be a continual focus.

Audit committee questions:

- How is management treating the effect of remote working in considering whether a reassessment of business risk, control risk and the effectiveness of the related controls is needed? Were there any changes needed to the design of internal control over financial reporting or the operators of those controls? What additional steps, if any, did management need to take to ensure that the controls were operating effectively and consistently to ensure the financial statements were accurately prepared?
- If management relies on third-party service providers for support in closing the books, what procedures did management perform to ensure that these services were appropriately performed?
- Are there any significant updates or changes in management's representation letter to the external auditors as a result of the challenging circumstances?
- Have there been any changes to materiality assessments because of changes in current or forecasted financial performance?

Risk factors, related effects and other disclosures pertaining to COVID-19

Temporary lock downs as a result of COVID-19 have impacted almost all the business in Pakistan and the disclosure of the COVID-19 risks and related effects would be essential for users of the financial statements. As it relates to risk factors, if something has already occurred, the disclosure should no longer address the hypothetical "risk" of it occurring. Instead, it should describe what has occurred, and then disclose what the risk now is, such as the potential for the situation to worsen.

The entity should disclose in the financial statements that it believes will provide the reader with an understanding of the entity's financial condition, changes to the financial condition and results of operations. It should provide investors with information about the entity's known trends or uncertainties that have had, or that the entity reasonably expects will have, a material impact on net sales or revenues or income. Therefore, entities should be disclosing, to the best of their ability, how COVID-19 could impact the entity's financial performance including operations, cash flows, capital investment programs and liquidity. Entities will need to ensure that business plans are updated for the current environment and liquidity risks are assessed and disclosed.

Audit committee questions:

- What updates has the entity made to their disclosures / risk disclosures as a result of the implications of COVID-19?
- How has management stress-tested their assumptions when considering trends or uncertainties that are expected to have a material impact on the results of operations or capital resources going forward?

Technical accounting

Revenue recognition and receivables

The disruption in the supply chain as a result of lock downs and reduced consumer spending could have an impact on revenue recognition. While an entity may continue to sell products and services to customers impacted by disruptions caused by COVID-19, revenue can only be recognized for new sales if payment is probable. For sales already made by an entity and where there are outstanding receivables, the entity should assess the need for write-offs or reserves on outstanding receivable balances.

Changes in the way business is conducted (as a result of COVID-19) must also be identified on a timely basis to address any accounting or reporting implications, such as guarantees, side letters or other agreements that might address coverage of loss, right of return or other aspects that need to be appropriately accounted for and disclosed.

Audit committee questions:

- Is management comfortable that there have been no significant changes in business practices or, if there have been, have the related controls, accounting and reporting implications been assessed?
- What is the financial strength of the customer base and how is this reflected in the collectability of our receivables? Is the entity providing customers with any extensions, deferrals or other accommodations on payment terms, product financing or other support arrangements, and how are they being accounted for?
- Has the entity increased the period during which customers can make return of sales?
- Has the entity offered current customers future concessions, such as reducing the price or decreasing quantities of goods or services to be delivered (or minimum purchase commitments) and what is the expected impact on revenue?
- What is the financial strength of the supplier base? Is the entity providing suppliers with financing or other support arrangements and how are they being accounted for?
- Is the management comfortable that the required disclosures have been made in the financial statements as required under IFRS 15 and IFRS 9 (where applicable)?

For banking companies audit committee specific questions can be:

- Has the bank performed stress testing for its credit exposures in sectors most likely to be impacted by COVID-19 scenario and what are the results of this assessment?
- How is bank dealing with deferral of principal requests received from customers as allowed by the State Bank of Pakistan?
- How will such requests for deferral impact the liquidity of the bank?
- How will the decline in KIBOR rates impact the net interest income of the bank?
- How is the Islamic bank dealing with deferral of principal requests received from customers as allowed by the State Bank of Pakistan recognise revenue on the amount of principal portion deferred under Shariah guidelines?

Impairment of goodwill, intangibles and property, plant and equipment

COVID-19 may impact an entity's projected cash flows due to a decrease in demand for its product, supply chain disruptions, delivery challenges or other events. This might indicate impairment on entity's assets. In such situations, an entity needs to consider whether the disruption in its business and / or the broader market indicates that a "triggering event" has occurred or existed as of the balance sheet date (i.e. the measurement date). If the triggering event existed at the balance sheet date, an impairment assessment is warranted and the assumptions and cash flow forecasts used to test for impairment should be updated to reflect the potential impact of current conditions. Given the current environment of uncertainties, some entities might use an approach whereby they might create different time horizon scenarios and then assign probability weight to them considering the fact that there is no recent history for such a pandemic and the situation is still evolving.

Audit committee questions:

- How have budgets, forecasts and underlying assumptions been updated to reflect the increased risk and economic uncertainty?
- What are the key assumptions used to determine the forecasts and how has the relative probability of various outcome scenarios been assessed?
- Have the processes to derive and evaluate the reasonableness of the assumptions changed?

Valuations – fair value measurements for an unquoted investment

Information used in fair value models should be as of the reporting date. COVID-19 disruptions could cause delays in the availability of the information used in those models, for example, to measure the fair value of an investment. Initial estimates should be updated for any delayed information that becomes available prior to the release of the entity's financial statements if the information provides additional evidence about known or knowable conditions that existed at the measurement date.

Audit committee questions:

- What is the availability of information to be used in determining fair value?
- Where is management using estimates in the absence of timely reporting from investees and others?

Derivatives and hedging

Entities that have designated forecasted transactions in cash flow hedging relationships, such as inventory purchases, sales or revenues, debt issuances or interest payments, may have decreased their forecasts of transaction volume. Entities will have to consider the change in the probability of a hedged forecasted transaction and the impact on the financial statements. In addition, the current economic environment could potentially impact an entity's ability to continue designated hedges or even establish new hedges.

Audit committee questions:

- Are our risk management and hedging programs still appropriate in relation to our updated business forecast?
- Has uncertainty about forecasted transactions impacted our ability to apply hedge accounting?
- Are there any emerging counterparty risks due to current events and market conditions?

Inventory valuation

Inventories should be measured at the lower of cost and the net realizable value (NRV). Determining NRV at the balance sheet date requires the application of judgment and consideration of all available data, including changes in product prices experienced or anticipated subsequent to the balance sheet date. In addition, inventories should be written down during an interim period to the lower of cost and NRV unless substantial evidence exists that the net realizable value will recover before the inventory is sold in the fiscal year. Situations in which an interim write- down would not be necessary are generally limited to seasonal price fluctuations. Given the significant uncertainties associated with the current market conditions, it would be challenging for an entity to conclude that prices will recover before inventory is sold. Furthermore, for valuation of inventory, the entity needs to take care of the fact that IAS 2, "Inventories" requires that fixed production overheads are included in the cost of inventory based on normal production capacity. Reduced production might affect the extent to which overheads can be included in the cost of inventory.

Audit committee questions:

- How has management assessed inventory for NRV?
- Have "abnormal" production levels (i.e., production levels below the range of normal capacity) impacted how overhead is allocated to inventory?
- What is the plan to continually assess the NRV of inventory for adjustments?

Accounting for insurance claims

Business interruption insurance policies (e.g., loss of use of property or equipment) generally cover losses of gross profit or reimbursement of certain expenses while an entity is unable to conduct its business. When a business is interrupted, the write-down of an asset or the accrual of an obligation (e.g., salaries paid to idle workers) would be considered a loss recognized in the financial statements. However, the absence of expected revenue or income is not a loss recognized in the financial statements. Recovery of lost profits or revenue through an insurance claim would not be recognized until the contingency is considered resolved and realization of the claim for recovery is virtually certain. Typically, a business interruption insurance recovery gain would not be recognized prior to the insurance entity acknowledging that the claim is covered and communicating the amount to be paid to the entity. Any stipulation from the insurance entity (e.g., "pending final review") should be reviewed to determine whether it is an indication the claim may not be realizable. The entity's history in collecting such claims should also be considered.

Audit committee questions:

- What is the nature of the disruption to the entity's business and are such impacts covered by the entity's insurance policies?
- Has there been communication with the insurer such that the entity is comfortable recording a business interruption recovery gain in its financial statements? What were the considerations that supported management's conclusion that the claim is recoverable?
- Has management assessed whether the insurance entity has the financial wherewithal to pay the claim?

Debt

Entity may experience significant liquidity issues that may call into question compliance with debt covenants. As a result of the COVID - 19, some entities might find themselves in breach of loan covenants and in some cases material adverse change clause might be triggered. This could result in loan repayment terms changing and some loans becoming repayable on demand. Entity needs to consider whether there is a need to classify any long-term debt as current.

It is important to note that many entities may seek rescheduling / restructuring of their financial obligations with the financial institutions. Such rescheduling and restructurings might include requests to the financial institutions to give relaxation in respect of certain loan covenants. Such relaxations for loan covenants should be obtained by entities before the reporting date to continue the existing loan classification between the non-current and current.

Debt restructuring during an economic downturn also requires a number of considerations. It should be assessed to determine if it is a modification or extinguishment under the requirements of IFRS.

Audit committee questions:

- Is the entity at risk of failing any debt covenants as of the period end or during the next 12 months?
- Are there any subjective acceleration clauses in our debt agreements and are these appropriately disclosed when necessary?
- Has the entity been granted any waivers of violations or modified any covenants to avoid a violation?
- Is the entity's disclosure related to potential debt covenant violations appropriate?

Taxes

Entity must reassess the need for a valuation allowance on deferred tax assets at each balance sheet date. If operating results have deteriorated, or if other negative evidence has developed, it would be appropriate for entity to revisit its valuation allowance conclusions.

Audit committee questions:

- How has management assessed the need for a valuation allowance, or change thereto, against deferred tax assets? Are the supporting cash flow forecasts consistent with those made for the entity in other areas of accounting and disclosed to shareholders?
- Has appropriate disclosure been made in the financial statements, where there has been a change in valuation allowance for deferred tax assets?

Subsequent events

Entity should consider whether events that occurred subsequent to the balance sheet date but prior to the issuance of the financial statements need to be reflected in the financial statements. Determining whether an event is recognized or unrecognized can be more difficult when circumstances are evolving versus evaluating a single isolated event. When events develop over a period of time, some portions of the impact may be recognized, while other portions are unrecognized. Recognized subsequent events are recorded in the financial statements to be issued. Examples include the realization of a loss on the sale of inventory or property held for sale when the subsequent event confirms a previously existing unrecognized loss.

Changes in lower of cost or NRV considerations related to inventory valuation in the subsequent period may also be recognized subsequent events. However, when a specific event results in the loss of value of the inventory, such as discrete decisions to close stores or governmental actions to restrict individuals' activities that may not have been reasonably predicted as of the balance sheet date, the inventory would be impaired in the same period that the specific event occurred. Similarly, the effect of a change in tax law is recorded discretely as a component of the income tax provision in the period of enactment. Entity will need to assess the timing of the COVID-19-related events to determine the impact on financial statements reporting.

Audit committee questions:

- Were there any significant events, or new insights, that management became aware of after the balance sheet date that they believe should have been recognized in the financial statements?
- What are the disclosures planned around post-balance sheet events that are not recognized?

Going concern

Financial statements are prepared assuming that an entity will continue to operate as a going concern. Management needs to assess going concern at each annual and interim reporting period with a look-forward period of one year from the financial statement issuance date. Entities impacted by COVID-19 will have to update their forecasts, and if conditions give rise to uncertainties about the ability to continue to operate (e.g., recurring operating losses), it will be necessary to make adjustments in the financial statements (e.g., record asset impairment losses) and provide disclosures to alert investors about the underlying financial conditions and management's plans to address them.

Audit committee questions:

- Has management identified substantial doubt about the entity's ability to continue as a going concern?
- Is it probable that management's plans, when implemented, will mitigate the conditions that give rise to substantial doubt within the assessment period (that is, one year from the issuance date)?

Our insight on COVID-19

We're operating in uncharted waters. Critical information on the characteristics of COVID-19 and its impacts on business are difficult to assess and can change overnight. We aim to provide a variety of insights on how entities can focus their efforts.

Accounting implications of the impacts of COVID-19 – An Overview of IFRS Requirements.

PwC's COVID-19 Navigator - an online, interactive tool to help organizations better understand where they are on their path toward COVID-19 preparedness and response.

Responding to COVID-19: Considerations for Board of Directors – An overview on matters relevant for the Board of Directors.

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