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Contents

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Introduction	Page 3
Post balance sheet events	Page 4
Impairment of assets	Page 5
Going concern	Page 6
Revenue recognition	Page 7
Accounting for Government aid	Page 8
Onerous contracts	Page 9
Loan covenants and borrowings	Page 10
Other implications	Page 11
Contact us	Page 12

Accounting Issues Arising From Covid-19

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The Covid-19 global pandemic brings with it many accounting challenges and issues that may arise in the preparation of a Company's latest financial statements.

In this publication we explore some of the key issues that may arise and those which will need consideration by finance teams and Directors during the preparation of the financial statements under Financial Reporting Standard 102 ("FRS 102"). Similar issues arise for companies with a year end prior to the outbreak and those with a year end after the outbreak.

Some of the key issues that may arise will include:

- Post balance sheet events
- Impairment of assets at the balance sheet date
- Going concern
- Revenue recognition
- Accounting for government aid
- Onerous contracts
- Loan covenants and borrowings
- Other issues

Post balance sheet events

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Depending upon a company's year-end, the impact of Covid-19 might be an adjusting or a non-adjusting event.

December 31 2019 year end

For companies with a 31 December 2019 year-end, the outbreak and spread of the virus after 31 December 2019 is a non-adjusting event because only a few cases of the virus had been reported globally prior to the year end. As a result the subsequent spread, and impact, of Covid-19 after 31 December 2019 does not provide additional information about the conditions that existed as at 31 December 2019. As a result this is therefore a non-adjusting event. However, for companies with later year-end dates the year-end balances might be affected.

Companies must ensure that non-adjusting events are disclosed within the financial statements, if material. The disclosure of non-adjusting post balance sheet events should include the nature of the event, i.e. Covid-19, and an estimate of the financial effect of the Covid-19 outbreak.

Some examples of non-adjusting post balance sheet events arising from Covid-19 might include the following:

- Changes in values of assets and liabilities as a result of the Covid-19 outbreak
- Major restructuring announced post year end
- Abnormally large changes in asset prices or foreign exchange rates
- Entering into significant commitments or contingent liabilities, for example, the obtaining of a loan under the Government's Coronavirus Business Interruption Scheme ("CBILS")

Other year ends

For companies with a year end other than 31 December 2019, the impact of Covid-19 will be a current period event and therefore impact on the measurement of assets, liabilities, income and expenditure.

Impairment of assets

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For companies with a year end after 31 December 2019 the Covid-19 outbreak gives rise to conditions that existed at the balance sheet date and therefore must be considered when considering the need for impairment reviews.

Fixed assets

Management should review the carrying values of assets and liabilities at the balance sheet date, including tangible fixed assets and intangible assets such as goodwill and review whether these are showing signs of impairment as a result of the Covid-19 outbreak.

For these items the key considerations will be:

- Are the future profits and therefore cashflows arising from the asset affected by Covid-19?
- Has Covid-19 resulted in a shut down or part or all of the business?

If the answer is yes to either of the above then it may be appropriate for management to undertake an impairment review of the tangible or intangible fixed assets. This impairment review should use the forecast cash flows and operating results that are expected to arise due to the Covid-19 outbreak. i.e. these forecasts should be reviewed and updated for the impact of Covid19 before undertaking the impairment review. Any impairments arising at the balance sheet date should be accounted for at that date.

Current assets

Current assets such as debtors and inventories should also be considered for impairment at the balance sheet date. In the case of inventories, these should be held at the lower of cost and net realisable value (“NRV”). If NRV has been impacted as a result of Covid-19, because, for example the inventory held cannot currently be sold and will need to be sold at a discount later or will become obsolescent as a result of Covid-19, then the amount should be written down to this Covid-19 adjusted NRV. This may result in stock losses being reported in profit or loss at the reporting date.

For assets such as trade debtors, the recoverable amount of these may also be impacted, for example, if a trade debtor can no longer pay an amount that is due because they have been severely affected by Covid-19. Where there are indications that recovery of a debtor is threatened by Covid-19, management should consider the need for a provision of this debt at the balance sheet date.

Going concern

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Financial statements are prepared on a going concern basis unless management intends either to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

The assessment as to whether the going concern basis is appropriate takes into account events after the end of the reporting period. For example, for 31 December 2019 reporters that are severely affected by Covid-19, even though the significant impact on operations occurred after the year-end, it will be necessary for management to consider the appropriateness of preparing financial statements on a going concern basis. It is important for management to remember that they must consider a period of at least 12 months from the date of approval of the financial statements, not the reporting date.

When management is aware of material uncertainties that cast a significant doubt on the entity's ability to continue as a going concern, the entity should disclose those material uncertainties in the financial statements.

It is likely that a number of entities will include disclosure in respect of material uncertainties in the preparation of their financial statements that are approved after the Covid-19 outbreak was known. Management should consider these disclosures carefully and ensure that enough information is provided to the users of the accounts in order that those users may make informed decisions surrounding that entities current financial position.

Although uncertainties will be specific to each entity items such as the future cashflows and profits of the business as well as any funding requirements should be considered when management are making this assessment. A specific situation that may arise is the requirement for additional bank funding, for example, through the Government CBILS scheme. Where it is expected that this funding will be received at a later date but is not approved at the date of the approval of the financial statements this may give rise to a material uncertainty.

Where financial statements are audited there may be a need for the auditor to draw attention in the audit report to these material uncertainties.

Revenue recognition

Covid-19 presents a number of potential issues in respect of revenue recognition for companies. FRS 102 permits revenue only to be recognised when certain criteria are met:

- When goods are sold that the entity has transferred to the buyer the significant risks and rewards of ownership of the goods and the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- The amount of revenue can be measured reliably;
- It is probable that the economic benefits associated with the transaction will flow to the entity;
- Where services are provided that the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
- The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

The main issue that Covid-19 presents in respect of revenue recognition arises with the third point and whether the company can reliably estimate that the economic benefits associated with the transaction will flow to the entity. Ordinarily a company would not enter into a transaction if they did not believe that the resulting economic benefits would flow to them, but many of these contracts would have been entered into prior to the Covid-19 outbreak. It may be that the impact of Covid-19 have resulted in that flow of economic benefit becoming uncertain because the company receiving the goods or services is experiencing significant financial difficulties.

Where the provision of services has been impacted by Covid-19, for example, as a result of not being able to access the clients premises management will need to carefully consider whether the services provided can be reliably measured and would give rise to a flow of economic benefit. It may be that the non-completion of the service to an appropriate point restricts the revenue that can be recognised in that instance.

Accounting for Government aid

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Many companies in the UK will have received Government aid in the form of grants and the Coronavirus Job Retention Scheme ("CJRS"). Further details of the Government help available can be found here on our Covid-19 practical advice document.

The Government aid that has been provided will need to be accounted for in line with section 24 of FRS 102, Government Grants.

Section 24 states that Government grants may not be recognised until there is reasonable assurance that the entity will (a) comply with the conditions attaching to them and (b) the grants will be received. An entity must recognise grants either based on the performance model or the accrual model. Grants related to income are presented as part of profit or loss, either separately or under a general heading such as other income. Specifically the CJRS grant received should not be netted off from wages and salaries costs.

For companies with a March year end, it would be reasonable to accrue the income from the CJRS at that date despite the portal not opening for applications until 20 April 2020 to ensure the income is recognised on a accruals basis.

Onerous contracts

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For companies with a year end of December 2019 the Covid-19 outbreak would not give rise to an onerous contract because, as previously noted, the conditions did not exist at the balance sheet date. They may of course have onerous contracts for other reasons.

For companies with year ends other than December, management may need to give consideration of contracts that have become onerous as a result of the Covid-19 outbreak. Most companies would have a number of contracts in place at year end that ordinarily they would have expected to be profit making or break even. If as a result of Covid-19, or any other reasons management believe that a specific contract will now become loss making, then the loss expected on that contract should be provided for in full at the balance sheet date.

Management should consider the terms of contracts carefully when deciding whether a contract has become onerous. Some key things to consider are as follows:

- Does Covid-19 now mean that the contract cannot be finished within agreed timescales meaning penalty clauses are activated?
- Are there constraints on the availability of materials and labour as a result of Covid-19 meaning that previously expected costs are going to be higher than first thought?
- Are labour costs on a specific project now considered to be higher than anticipated due to inefficiencies arising from home or remote working?
- Has an announced restructuring of the business and the closure of specific sites meant that an operating lease for premises will now not generate a profit in the future?

Whilst FRS102 requires the recognition of losses on individual onerous contracts or leases it does not permit the provision of future operating losses of a business that may arise from Covid-19. So if a retail business, for example, is forecasting losses over the coming months as it has no income to offset its staff costs it is not permitted to recognise those losses at the balance sheet date.

Loan covenants and borrowings

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Where companies have borrowings from banks or other providers there are almost always financial and non-financial covenants that must be complied with. Breaching these covenants as a result of Covid-19 or any other reason will have implications on the disclosure of amounts in the financial statements. The variation of terms of loans as a result of Covid-19 will also potentially result in a change in accounting treatment or disclosure of loans.

31 December 2019 year end

For companies with a December 2019 year end any breaches or changes in loan terms and conditions will not affect the amounts reported in the balance sheet or the classification of loans between due within one year and due in more than one year. If a company has breached loan covenants post year end then the Directors will need to consider this in arriving at their assessment of going concern. Any major changes in loan structure or additional borrowings may need to be disclosed as a post balance sheet event.

Other year ends

For those companies with year ends other than December that breach loan covenants, FRS102 requires the presentation of all amounts due under that loan agreement to be presented as a creditor due within one year, regardless of the contractual repayment terms included in the loan agreement.

Where debt has been restructured during the year management will need to give consideration to the accounting of arrangement fees and other fees incurred in obtaining the loan. In addition, where interest rates have changed or other conditions amended, such as repayment periods, management will need to give consideration to the disclosure of these in the financial statements and the impact that it may have on the accounting for things like arrangement fees previously incurred.

Other implications

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Employees costs and contracts – It may be the case that employee contracts or terms and conditions have been amended to account for different working arrangements as a result of Covid-19. These changes could result in changes to amounts previously recognised in the financial statements. For example, if employers have agreed that employees can carry over unused holiday to future periods this will impact on the calculation of the year end holiday pay accrual required under FRS102.

Deferred tax assets – Where companies have unused tax losses which are recognised as deferred tax assets at the year end management will need to carefully consider whether, in light of revised budgets and forecasts, the assets are still recoverable. This is particularly relevant where future years budgeted profits are forecast to be lower than previously anticipated.

Insurance cover – It is possible that some companies will claim under insurance cover for the impact of Covid-19 on their business and where this is the case, careful thought must be given to whether this gives rise to an asset and income at the balance sheet date. FRS 102 requires the recognition of an asset, in this case the insurance claim receivable, only when the receipt of that asset is virtually certain. It may be that at the year end it cannot be claimed with any certainty that an insurance claim will be successful. In this instance disclosure of the asset that might be received in a future period might need to be made in the financial statements, if material. Even if the insurance claim is successful post year end this does not mean that the outcome was virtually certain at the balance sheet date.

Strategic report – When preparing the strategic report for the period, the Directors will need to consider the impact that Covid-19 has had on the business, if any, and provide information around this in the narrative elements of the strategic report. Particular focus will need to be given to the risks that the business is facing and how the Directors have tried to mitigate these. Where the impact of Covifd-19 is material and is expected to have a material impact on a future period the strategic report can provide users of the financial statements with information to better understand the impact on the business.

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