

## Important implications for the preparation of UK accounts under FRS 102 as a result of COVID-19

*Tony Castagnetti*  
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COVID-19 has evolved into a pandemic affecting the entire world and resulted in almost all countries adopting lockdown strategies and businesses suddenly finding themselves in very different circumstances to what they would have imagined 12 months ago. The full impact of this will not be seen in the financial statements for the years that ended on 31 December 2019 but will affect the current 2020 year.

The Financial Reporting Faculty has created a checklist for the UK Institute of Chartered Accountants in England and Wales to assist companies and accountants with some of the major factors to consider on the preparation of the financial statements with early 2020 year ends and subsequent year ends. This also needs to be taken into very careful consideration by auditors and what impact it could have on their audit reports.

A fundamental principle in the preparation of accounts is that they should reflect the conditions that existed at the balance sheet date. What this means is that information which comes to light after the balance sheet date which provides evidence of conditions that existed at the balance sheet date, should be adjusted for and reflected in those amounts recognised in the accounts. This is referred to as an adjusting post balance sheet event.

However, information indicative of conditions that arose after the balance sheet date should be disclosed in the notes to the accounts when material but not adjusted for at the balance sheet date, unless the business has ceased to be a going concern. These are referred to as non-adjusting post balance sheet events.

COVID-19 was unknown of as at 31 December 2019 and therefore any impact from it would not be an adjusting event at 31 December 2019 but rather a disclosure in the notes to the accounts as a material post balance sheet event.

However, for year ends ending in 2020, this will not necessarily be the case and consideration needs to be given to adjusting events which will impact on the numbers and the balance sheet net position.

Below are the key issues and considerations to be taken into account as raised by the Financial Reporting Faculty in their checklist.

### **1. Does the carrying value of stock need adjustment?**

This is of particular importance to the retail sector where stock is purchased based on seasons. We have seen in the press and highlighted on the news where some major retailers have cancelled contracts and orders with Bangladesh. This is because of this very reason and with lockdown resulting in reduced sales, the need to avoid being left with high volumes of stock that would need to be written down becomes a major issue to retailers. Other sectors affected would be ones where stock has a short shelf life or where there is likely to be a major drop off of demand for the products which may not just be short term.

There may also be higher input costs and delivery charges affecting the estimated costs to complete and sell which could impact the valuation at the year-end which is at the lower of cost versus net realisable value.

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### 2. Could bank covenants have been breached?

Unless companies have spoken to their banks and obtained confirmation before the year end that any breach of covenant would be waived due to the impact of COVID-19, it could be that long term liabilities may need to be reclassified as short term and repayable on demand. This could impact credit ratings and takes on a significant importance.

### 3. Are debtors fully recoverable?

COVID-19 has affected virtually all businesses. Where debtors exist with companies or individuals that have been adversely affected, the recoverability of these debtors need to be carefully reviewed. When there is objective evidence that the debtors as at the balance sheet date are not recoverable, they must be written down immediately.

### 4. Is the business a going concern?

An entity is a going concern unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so. When assessing whether the going concern basis of accounting is appropriate, the management must consider all the available information about the future which is at least, but not limited to, 12 months from the date when the financial statements are authorised for issue. The auditor does likewise, and the conclusion of his work may impact on the wording in his audit report.

The impact of COVID-19 must therefore be reflected in the going concern assessment for all financial statements being produced now, even if the year-end is on or before 31 December 2019.

If the business is not a going concern, adjustments may be necessary to the carrying amounts of assets and liabilities in the financial statements. Long term assets and liabilities will need reclassifying as short term and additional costs accrued for closing the entity down. This may be of particular relevance to the hospitality sector where restaurants, pubs, bars and hotels have all closed due to the lockdown, but not all are likely to reopen again, and some may well have no option but to cease trading permanently.

### 5. Taxation

The UK government's time to pay arrangements have enabled entities and individuals to defer tax payments to future dates. These need to be considered when preparing financial statements as to their disclosure as either short term or long-term liabilities.

Deferred tax assets also need to be carefully looked at as these are mainly dependent on the entities making future taxable profits. The impact of COVID-19 on the business may reduce the probability of future profits to what would have been anticipated before the outbreak, thus potentially reducing materially any deferred tax asset.



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### **6. Has there been any impairment to fixed assets?**

COVID-19 means that many businesses are not able to operate as normal. This, together with the negative impact on the economy more generally, are likely to be indicators of impairment to the extent these conditions existed at the balance sheet date. This would apply to 2020 year ends and an example would be goodwill. The effect of the pandemic could be that the business may not recover to what it was before. Examples could be the airline industry where sizeable redundancies are already being made and the holiday sector such as cruise liners.

In such circumstances, the entities will need to assess the recoverable amounts of the assets affected and consider whether there has been any impairment of its assets – both tangible and intangible.

### **7. Have existing contracts become onerous?**

Some contracts that may have previously been considered profitable (or break-even) may now be considered onerous e.g., operating leases for aircraft, restaurants or retail space. A provision will be required for any present obligation at the balance sheet date. This would involve recognising the entire amount of the remaining lease payments less any offsetting sublease income as a provision in the year.

### **8. Recognition of restructuring plans.**

Many businesses will be reviewing their operations, for example reducing staffing levels, mothballing certain activities or selling some of the company's assets. Evidence of this has already been seen within the airline industry, car manufacturing, retailers confirming the closure of outlets post lockdown, etc. A restructuring provision must be recognised only to the extent that there is a constructive obligation at the balance sheet date alongside the general recognition criteria for provisions, therefore it is important to review and note the documentation and evidence as to when the decision was made and notified.

### **9. Will any losses be covered by insurance policies?**

Some businesses may well that they have cover in place that would pay out against losses from business interruption that may well include pandemics. Insurance recoveries should be recognised only when virtually certain. If the insurance recovery is probable at the balance sheet date, a description of the contingent asset and, when practicable, an estimate of the financial effect must be disclosed. If an insurance recovery becomes virtually certain only after the balance sheet date, the amount should be disclosed as a non-adjusting post balance sheet event when material.

### **10. What has been received as government assistance?**

The government has introduced a range of initiatives to help businesses including the Coronavirus Job Retention Scheme, business rates holidays and grants for certain sectors. Government grants may not be recognised until there is reasonable assurance that the entity will:

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- (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'.

The performance model allows the recognition of the grant:

- On receipt of the proceeds where the grant does not impose any performance related conditions; and
- When the performance related conditions are met.

The accruals model allows the recognition of the grant:

- Over the expected life of the asset and the amount deferred shown as a liability on the balance sheet;
- or
- Over a systematic basis over the period the entity recognises the cost where the grant is revenue in nature.

### **11. Have contracts with employees been modified or terminated?**

Numerous businesses will have furloughed their employees and applied for the UK government's 80% contribution. This contribution is not free money and will either reduce any taxable loss to carry back or increase the taxable profit subject to corporation tax in the year.

Modified or terminated contracts may also have implications for the amounts recognised as employment costs in the year. Additional holiday pay accruals may exist for staff allowed to carry forward unused holiday as a result of COVID-19. There may also be implications on accrued bonus payments, pension liabilities and any share-based payments.

### **12. Accounting policies and disclosure in the notes to the financial statements.**

All financial statements are required to give a true and fair view and the disclosure requirements vary according to the size of the entity and for small entities, whether Section 1A has been applied.

However, under the current climate and the significant uncertainty faced by businesses as a result of COVID-19, it has never been more important to be transparent and honest about risks faced by the business and the assumptions used in the financial statements, and making the disclosures as specific to the business as possible.