ANNEXURE-A

POTENTIAL COVID-19 IMPACT ON FINANCIAL REPORTING AND AUDITING

PART A: FINANCIAL REPORTING IMPACT

What started in the Chinese city, Wuhan in Hubei province during December 2019 as an outbreak of unknown virus, was declared as a Pandemic by World Health Organization (WHO) on 11 March 2020 with a name tag of COVID-19. This Pandemic has created global disruption at an unprecedented level and at such speed that most of us could not comprehend even couple of weeks earlier. Along with great human toll and impact on public health, COVID-19 has also created devastating effect on global trade, commerce and industry with consequential implications on financial reporting by the affected entities and audit of financial statements of those entities.

Although COVID-19 originated during December 2019 but as at 31 December 2019 it was not widely known outside China nor any impact of this was felt anywhere outside China. COVID-19 started to get global attention only towards end of January 2020 when WHO declared this as health emergency on 30 January 2020. Finally, on 11 March 2020 WHO declared it a Pandemic and by this time COVID-19 has created a global shock and disturbance not seen in many decades.

To tackle outbreak of COVID-19, many countries went for complete lock down running into weeks, closed international borders with restriction on movement of people, implemented social distancing and other strict conditions. All these measures have severe effects on global trade and commerce in many forms ranging from supply chain disruptions to closures of business activities. To support business and economic activities during this critical time and ensure liquidity in the market Governments across the world has announced various types of economic stimulus program.

The Government of Bangladesh has also announced a number of economic stimulus packages for affected businesses. The major stimulus packages declared so far are creation of BDT 5,000 crore loan fund at 2% interest rate with relaxed repayment term for export-oriented industry to pay labour wages for next three months, special loan funds with lower interest rate of BDT 30,000 crore for big industries and service sector and BDT 20,000 crore for small and medium enterprises (SMEs) including the cottage industries, Export Development Fund (EDF) loans, extension of tenure for settlement of foreign currency loans, reduction in CRR requirement, re-fixation of repo rate, direct purchase of additional government securities in excess of SLR requirement from secondary market on market price etc.

Since every business and industry would have different impacts from COVID-19, it is very important for each entity to make its own individual assessment. We have considered COVID-19 impact on financial reporting in two groups; one group are those entities with 31 December 2019 reporting date and the other group are those entities with the reporting date of 31 March 2020 or later. Entities preparing interim financial statements for the quarter/period ended 31 March 2020 shall also be considered in the second group.

I. First Group of Entities with reporting period ended on or before 31 December 2019

For entities with the reporting date of 31 December 2019 or earlier, the financial reporting effects of the COVID-19 outbreak are generally **non-adjusting events** (with the exception of going concern) because the significant changes in business activities and economic conditions as a result of COVID-19 events took place well after the reporting date (i.e. declaration of pandemic and actions taken to contain the COVID-19 outbreak).

IAS 10 has defined non-adjusting event as an event after the reporting period that is indicative of a condition that arose after the end of the reporting period, and an adjusting event as an event after the reporting period that provides further evidence of conditions that existed at the end of the reporting period and on the other hand. As stated above, applying this definition of IAS 10, for entities with reporting period ended on or before 31 December 2019 other than going concern COVID 19 related matters are most likely to be non-adjusting events. In Bangladesh, all Banks, NBFI, Insurance companies and their subsidiaries as well some foreign-owned/ multinational entities are classified into this Group. Depending on the timing of the financial statements authorized for issue, disclosure of COVID 19 related subsequent events including potential financial impact, if known, may require in the financial statements or annual report of these entities.

Going concern

Management should consider the potential implications of COVID-19 when assessing the entity's ability to continue as a going concern. An entity is no longer a going concern if management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue. Material uncertainties that might cast significant doubt upon an entity's ability to continue as a going concern should be disclosed in accordance with IAS 1.

The assessment will be specific to the entity's circumstance and also to consider external supports expected by the entity (i.e. declaration of salary support for export industry, deferral of loan repayment, additional borrowing at lower interest rate etc.). While conducting going concern assessment, the entity need to specifically consider the extent of operational disruption, potential reduction in demand for products or services, contractual obligations due or anticipated within one year, potential liquidity and working capital shortfalls and access to existing sources of capital. In making its going concern assessment, IAS 10 Events after the Reporting Period requires an entity to consider events up to the date of authorization of the financial statements.

If the entity is a going concern, the financial statements should be prepared on a going concern basis. If not, they should be prepared on a basis other than going concern. An entity shall not prepare its financial statements on a going concern basis if events after the end of the reporting period result in the going concern basis becoming inappropriate. Due to such rapid changes in economic environment from COVID-19, an entity at 31 December 2019 reporting date may be a going concern, but on the date when financial statements are authorised for issue no longer a going concern due to COVID-19 impact, and in such case the going concern basis shall not be used.

II. Second group of entities with reporting period ended on or after 31 March 2020 including interim reporting

For entities with reporting periods ended on 31 March 2020 or subsequent date (i.e. 30 June 2020) as well as those entities reporting interim financial statements for the Quarter/period ended 31 March 2020, all COVID-19 related impacts are current period events requiring appropriate recognition in the financial statements.

Changes in the economic activity caused by the Pandemic will cause many entities to renegotiate the terms of existing contracts and arrangements, and even cancellation of contracts/orders. As we have seen in Bangladesh, many overseas buyers of local RMG and Textile products abruptly cancelled or deferred confirmed orders and some even refused to accept those orders awaiting shipment or in the final stage of delivery. Such situation may result multiple implications on financial reporting including but not limited to going concern assumption, revenue recognition (IFRS 15), inventory valuation (IAS 2), impairment assessment (IAS 36), onerous contract (IAS 37), debt servicing and compliance with covenants (IFRS 7) etc. In addition, contract modifications may result changes in terms of financial assets and liabilities (IFRS 9), leases (IFRS 16), compensation arrangements with employees (IAS 19) etc.

Similarly, an entity use forecast information (i.e. cash flow, production capacity utilization, etc.) for multiple purposes such as, the impairment of non-financial assets, expected credit losses, fair value of assets and liabilities, the recoverability of deferred tax assets and the entity's ability to continue as a going concern. Because of COVID-19 impact, preparation of reliable forecast information can be challenging and need to be closely monitored as this can have pervasive impact across multiple elements of financial statements.

The key potential financial reporting impacts are summarised as follows:

- **Impairment of non-current assets and goodwill**

Due to the lower demand of products, many entities would reduce its operation and some may have closed the operation altogether resulting lesser utilization of capacity and hence potential impairment of PP&E. Also due to adverse impact on future cash flows resulting from lower sale/demand of products or services, any goodwill recognized during business combination may need to be impaired (IAS 36).

- **Significant Increase in Credit Risk (SICR) and Expected Credit Losses (ECLs)**

IFRS 9 sets out a framework for determining the amount of expected credit losses (ECL) that should be recognised. It requires that lifetime ECLs be recognised when there is a significant increase in credit risk (SICR) on a financial instrument. Management shall apply judgment and adjust their approach to determine ECLs in different circumstances. A number of assumptions and expectations underlying the way ECLs have been implemented previously may no longer remain valid in the current situation resulted from COVID-19. Therefore, each entity needs to re-assess their credit risk, timing and uncertainty of future cash flows, moratorium in repayment declared by Government, potential insolvency of customer and other related factors to calculate provision for impairment of financial assets (IFRS 9).

IFRS Foundation on 27 March 2020 has issued a publication on “Accounting for expected credit losses applying IFRS 9 *Financial Instruments* in the light of current uncertainty resulting from the COVID-19 pandemic” which can be referred for further guidance on ECL impact. It is however, worthwhile to mention that in Bangladesh, Banks and NBFI follow Bangladesh Bank Circulars to calculate required loan loss provisions which are based on actual duration of overdue/arrear and hence, IFRS 9 ECL model is not followed for those entities. Nevertheless, other entities having trade and other receivables need to consider COVID-19 impact to assess ECL of those balances.

- **Fair value measurement**

Due to significant changes in macro-economic assumptions as well as entity specific conditions from COVID-19, key estimates and variable previously used for fair value measurement of assets and liabilities (i.e. Level 2 and Level 3 inputs) may be no longer valid and hence require re-assessment and supported by the latest input (IFRS 13).

- **Revenue Recognition**

Due to cancellation of orders and modification of contractual arrangement with customers factors such as probability of return, further discount, timing of transferring risk and reward due to supply chain disruption need to be assessed before recognizing revenue (IFRS 15).

- **Valuation of inventory**

Since inventories shall be measured at lower of cost and net realizable value, subsequent reduction in selling price of goods or cancellation of customer orders may indicate lower net realizable value of related inventories and hence write down may require (IAS 2).

- **Employee benefits**

Due to COVID-19 there may be changes to remuneration policies and especially for defined benefit plan changes in key actuarial assumptions (i.e. lower discount rate, lower return from financial assets due to reduced interest rate) which shall be considered (IAS 19).

- **Provisions for Onerous contracts**

Delay in fulfilment of contractual obligations may result in penalties or compensation claims unless otherwise protected and need to be provided for (IAS 37).

- **Deferred tax assets**

If any deferred tax asset is recognized on carry forward tax losses the related assumption need to be revisited especially whether the entity can still make adequate taxable profit after COVID-19 impact which will be available to offset such carry forward tax losses (IAS 12).

- **Leases**

With adverse impact in business many leases which were earlier expected to be renewed and therefore used in calculation of lease assets/liabilities may not be renewed now and hence need to be revisited along with new calculation of lessee’s incremental borrowing rate on account of change in its borrowing costs consequent to lower interest rate, decline in its credit rating, etc. (IFRS 16).

- **Insurance claims**

COVID-19 would impact insurer from lower policy renewal, refund of premium for business cancellation, higher claims, and lower returns from investment. On the other hand, an entity taking insurance policy may need to assess whether it is entitled to any claim/ compensation from loss of profits and business disruption including timing of recognition of such claim/ compensation.

- **Government stimulus package**

As stated above, the Government of Bangladesh has announced a number of economic stimulus packages for affected businesses. However, so far all these packages are effectively loan arrangement with easier repayment option and at reduced borrowing rate to be disbursed by Banks and NBFIs. Therefore, further scrutiny of these incentives are required along with other existing regulatory frameworks, before an assessment can be made whether such incentive would fall under 'IAS 20: Accounting for Government Grants and Disclosure of Government Assistance'. Since any impact of Government Stimulus packages would take place only after 1 April 2020, we shall cover this in more detail in our subsequent analysis.

PART B: IMPACT ON AUDIT OF FINANCIAL STATEMENTS

The COVID-19 related challenges on an auditor while conducting audit of financial statements are described below:

Travel and other movement restrictions

Due to increasing restrictions on travel, meetings and access to client locations for COVID-19 (i.e. in Bangladesh, Government has declared holiday initially from 26 March to 4 April 2020 which is now extended to 25 April 2020), auditors are facing practical difficulties in carrying out audits. Despite all these logistical challenges and underlying conditions, the delivery of high quality audit cannot be compromised. Audits should continue to be planned and performed in compliance with the International Standards on Auditing (ISA). To enable the auditors to perform audits, additional time may be required and alternative audit procedures may need to be performed in order to obtain sufficient appropriate audit evidence.

The auditor should immediately communicate any logistical challenges to conduct audit with both management and 'Those Charged With Governance (TCWG)' including any additional support they require from the client. The auditor should consider alternate audit procedures to obtain sufficient and appropriate audit evidence.

For example, if a client's year-end is 31 March 2020 and due to country-wide lockdown the Auditor could not able to attend/observe physical stock take, another stock take attendance shall be arranged immediately at a subsequent date and physical balance found during the subsequent date stock take shall be reconciled to the stock report at the year-end (ISA 501 Audit Evidence - Specific Considerations for Selected Items). In such case, the auditor may add an 'Other matter' paragraph in audit report in accordance with 'ISA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.'

Similarly, if an auditor is conducting audit of consolidated financial statements due to COVID-19 related matters audit procedures on the component FS including reviewing work component audit could not be performed as per 'ISA 600 Special Considerations—Audits of Group Financial Statements' or the auditor may not able to receive direct external confirmations from banks, debtors, lawyers, suppliers etc. in accordance with 'ISA 505 External Confirmations', the auditor need to consider whether alternate audit procedures can be applied.

If the auditor could not able to conduct any alternate audit procedures due to restrictions from COVID-19 and it was not possible to satisfactorily conclude on the basis of alternate audit procedures, the audit report may need to be modified in accordance with 'ISA 705 (Revised), Modifications to the Opinion in the Independent Auditor's Report.'

Going concern

ISA 570, Going concern confirms that the auditor's responsibilities are to obtain sufficient appropriate audit evidence and conclude on the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

The auditor will only be able to form a conclusion relating to going concern once management has made its own assessment. The auditor should inquire of management and those charged with governance as to what information available about the future, and determine whether this has been appropriately considered as part of management's assessment. The auditor should apply similar considerations to those of management, in assessing the appropriateness of the going concern assumption.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists. This should, for example, include a detailed and robust review of up to date forecasts, cash flows, sensitivity analyses and reviews of COVID-19 contingency plans and impact assessments conducted by management.

Impact on auditor's report

The implications of COVID-19 on the auditor's report will depend on the sufficiency and appropriateness of audit evidence obtained, the basis of preparation adopted and the disclosures provided in the financial statements.

For example, there is a situation where management has concluded that the entity is a going concern but there is a material uncertainty and if the auditor agrees that the entity is a going concern, and the material uncertainty is adequately disclosed in the financial statements, in the auditor's report, the 'conclusions relating to going concern' section should be removed and instead a 'material uncertainty related to going concern' section shall be included. However, if management is not willing to disclose material uncertainties, then the auditor may need to consider issuing a modified auditor's report.

Similarly, due to COVID-19 impact operating activities and cash flow of an entity can be significantly reduced during the first two quarters of 2020 and management has concluded that such reduction is temporary and once the outbreak is contained the entity would be back to its normal activities in very short period of time. Accordingly, management has not made any significant adjustment to the operating plan/cash flow forecast used for impairment assessment and just recalculated discount rate and other market related conditions. If the auditor concludes that management's assessment is reasonable but there is a risk that if the spread of outbreak is not contained by June 2020 there are some key assumptions that would require modification with possible impairment charges, the auditor can issue audit report with an EOM paragraph as per 'ISA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter Paragraphs' in the Independent Auditor's Report without any modification and highlighting the uncertainty.

Delaying the issuance of audit report

Given the unpredictable nature and impact of the COVID-19 outbreak, in some cases it might be appropriate to consider the possibility of delaying the approval of the financial statements and issuance of audit report until more certainty about the impact of such outbreak is known. For example, if Bangladesh Government has made general declaration of economic stimulus package to support a particular industry but the detail of that package is not yet announced and if management has assumed certain incentive from that Government package to support its going concern assumption, the auditor may like to wait until the detail package is announced to satisfactorily conclude on appropriateness of going concern assumption.

Consequently, auditors may not be able to meet previously agreed deadlines and required to wait for some time in order to satisfactorily obtain sufficient and appropriate audit evidence for issuing an unmodified audit report. If this is the case, the auditor should immediately inform both management and TCWG about the possible delay including the reason for such delay. Due to regulatory timeline for submission of audited financial statements, the client may need to approach the concerned regulators at the earliest opportunity to seek extension.

However, if the client is not willing to extend the timeline of completing the audit, the Auditor need to assess whether they have obtained sufficient and appropriate audit evidence to issue an audit opinion. If the answer is negative, the auditor needs to appropriately modify audit report.

Effective Communications

COVID-19 brought in significant changes at very fast pace with limited time to react by an auditor. At the same time, during this period of global turmoil and uncertainty, the users of financial statements in general and investor community in particular would expect to see high quality audit more than ever. Accordingly, this is quite complex time for an auditor with added public expectation and hence the auditor should maintain continuous communication line with management and TCWG and constantly made them aware of any audit related issue, be it restrictions of movement or difficulties in obtaining sufficient and appropriate audit evidence. Some of the matters need to be communicated with the TCWG, in particular with audit committee are as follows:

- Significant changes in the planned scope and timing of the audit, including new significant risks and modifications to the audit plan and key audit matters (KAM);

- Major difficulties/restrictions encountered during the audit in areas such as absence from physical attendance during stock take, unavailability of management for corroborative inquiry, lack of response in external confirmations etc. resulting lack of sufficient appropriate audit evidence and/or completing alternate audit procedures;

- Critical matters that were discussed or subject to correspondence with management, including disagreements on key estimates and judgments taken by management on COVID-19 related impact;

- Expected modifications to the auditor's report, e.g. modifications as a result of a scope limitation or disagreement, emphasis of matter paragraphs in respect of significant uncertainty, other matter paragraph to highlight alternate audit procedures etc.;

- Expected delay in finalization of audit due to changes circumstances and lack of clarity to validate reasonableness of management assumptions on key COVID-19 related matters. As mentioned above in the example that if management is planning to rely on Government support for going concern assumption and the detail of the support package is not yet available, the auditor may need to wait for satisfactorily conclude on the appropriateness of going concern assumption.

Validation of critical management estimates and judgments

As explained under financial reporting section, due to COVID-19 related issues, a number of areas in financial reporting shall be impacted and management need to make critical estimates and judgments about those matters. Such areas of critical estimates and judgments include among others, business plan and forecast to support going concern assumption, impairment assessment of non-current assets, expected credit losses, fair value of assets and liabilities without active market, etc. However, due to rapidly changing environment, in many such cases information and data used by management could be very difficult for an auditor to validate and assess for reasonableness.

Nevertheless, 'ISA 540 Auditing Accounting Estimate, including Fair Value Accounting Estimates, and Related Disclosures' require an auditor to evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable, or are misstated. In addition, auditor shall evaluate the adequacy of the disclosure of estimation uncertainty in the financial statements and review whether there are indication of possible management bias in making those estimates.

Accordingly, auditor shall observe all related steps outlined in ISA 540 and in other auditing standards to conclude that all critical management estimates and judgments are reasonable and should also obtain management representation as per ISA 580. However, if an auditor is unable to conclude on reasonableness of critical estimates and judgment applied by management they should discuss the matter with TCWG and try to resolve differences through developing a 'Point Estimate or Range' as prescribed in ISA 540. However, despite all these efforts if the disagreement persist and there are no alternatives, the auditor may consider modification of the audit report in accordance with ISA 705.

For ease of reference, a list of potential COVID-19 impacts on audit with reference to the related international standards on auditing are given below:

▪ Identifying new risks from COVID-19 related impact and re-assessments of the initial Risk of Material Misstatements (RMM) and Materiality in line with ‘ISA 315 (Revised) Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment’ and ‘ISA 320 Materiality in Planning and Performing an Audit’.

▪ Evaluate applicability of going concern assumption used by management for the preparation of the financial statements in line with ‘ISA 570 (Revised) Going Concern’.

▪ Consider all subsequent events from the date of year-end to the date signing audit report and assess whether these are adjusting or non-adjusting event requiring recognition and disclosure in the financial statements respectively and auditors obligation in accordance with ‘ISA 560 Subsequent Events’.

▪ Obtain specific representations from management especially on any estimates and judgments applied related to COVID-19 related impact in line with ‘ISA 580 Written Representations’.

▪ Formulation of Auditor's Opinion in accordance with ‘ISA 700 (Revised) Forming an Opinion and Reporting on Financial Statements’, ‘ISA 705 (Revised) Modifications to the Opinion in the Independent Auditor's Report’, ‘ISA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report’.

▪ Due to COVID-19 related impact if any changes is required in Key Audit Matters (KAM) previously communicated to TCWG updated KAM should be discussed with Management and TCWG in accordance with ‘ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report’.

▪ Risk of material misstatements in financial statements due to fraud including fraud risk factors identified previously may require re-assessment due to pervasive changes in economic environment from COVID-19 related impact and hence the auditor should consider this matter in audit in in accordance with ‘ISA 240 The Auditor's Responsibilities Relating to Fraud in An Audit of Financial Statements’.

▪ All listed entities in Bangladesh are required to publish annual reports and most likely there would be comments about COVID-19 and its impact on those entities in their annual reports. The auditor now has an added responsibility to read and comment on other information published along with the financial statements such as contents in annual report. Accordingly, the auditor should read such disclosure in the annual report and follow the steps prescribed in ‘ISA 720 (Revised) The Auditor's Responsibilities Relating to Other Information’.