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NEPAL FINANCIAL REPORTING IMPLICATION DUE TO COVID - 19

Accounting Period Ended Ashad 31, 2077

MOORE

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BACKGROUND

A sound environment with minimal vehicle horns, less toxic air from the industries, no drainage of wastage in the rivers from industrial work and more sanitized living habit has obviously pleased the nature in the recent days, but it has costed a good sum to the world economy. The coronavirus pandemic (COVID-19) has already lead to draw prediction about recession hitting the market of many countries depending on the longevity of lockdown.

The year when Nepal was ambitious and committed to attract 2 million foreign tourists following the "*Visit Nepal 2020*" campaign, have now unfortunately "U-turned" to be facing striking drop in tourist arrival rate. With the nationwide lockdown for countable number of months, entities have had to see unexpected numerical figures in their financial statement. Horizontally, it has challenged the preparers and auditors of the financial statement demanding various alteration in the reporting terms. Financial reporting frameworks are amended based on the past economic experiences; and many judgements, assumption and estimations about the future. However, the current issue of Covid-19 outbreak and its related events have demanded some major considerations to be adopted in financial reporting.

This publication is only intended to provide guidance about the key financial reporting implication aroused due to the pandemic. Specifically, it relates to the Nepal Financial Reporting Standards (NFRS) accordance to which financial statements ending on 31st Ashad 2077 is to be prepared.

A. GOING CONCERN

NAS 1 Presentation of Financial Statements states that management should assess the entity's ability to continue as a going concern for at least 12 months from the end of the reporting period taking into account all available information about the foreseeable future. Considering the fact that not all businesses are successful or can continue to be successful, regular assessment of various industrial, environmental & internal factors should be done that can doubt the ability of entity to continue in long run.

Presence of asset impairment, burdened debt, significant difference in the actual and expected profitability, negative cash flows, etc. are strong adverse indicator for going concern. A breach in the loan contract or valuable customer contract could create uncertainties raising doubt about entity's ability to continue as a going concern. Therefore, when assessing the entity's ability to continue as a going concern, management should consider the implications of COVID-19 and measures taken to control them.

Nepal experts have projected GDP growth to fall sharply to 2.3% from which we can assume the level of financial stress that Nepalese entities might face. The micro, small and medium enterprises are more vulnerable to the effect of pandemic.

So considering the pandemic situation, management are primarily responsible to identify any material uncertainty impacting the continuity position of their entity, the information should be clearly disclosed while preparing the financial statements of the company. The impact of COVID19 after the reporting date should also be considered and if, management after the reporting date either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so, the financial statements should not be prepared on going concern basis.

A. GOING CONCERN

Necessary disclosures as per NAS 1 shall also be made, such as material uncertainties that might cast significant doubt upon an entity's ability to continue as a going concern. In response to the COVID-19 pandemic, entities need to disclose how it is managing the risk, or entailment of any breaches and defaults related to its covenants.

The auditors of the financial statement are required to increase the skepticism for the assurance that entity is operating in going concern basis. Evidence of disruption to business operations, decrease customer's demand, or leading towards breaking of bank covenants or contractual obligations, which in turn leads to liquidity problems or operational difficulties for the entity should be focused on. Assurance upon proper presentation of every transaction affected directly or indirectly by the COVID-19 impact should be obtained.

B. INVENTORIES

As per NAS 2 Inventories, inventories shall be measured at the lower of cost and net realizable value, where the cost of inventories shall include all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. And, net realizable value is the net amount that an entity expects to realize from the sale of inventory in the ordinary course of business.

Amid the current situation of lockdown, manufacturing entities must probably had held massive bundle of work-in-progress inventory which are likely to have become obsolete, damaged or lost by the time it is converted into a finished good. Besides, the finished products might not have been reached in the hands of final consumers or entities might be facing unnecessary storage cost due to supply chain disruptions. Whole or partial obsolesce of inventory, or decline in selling price indicates the cost of inventories to be irrecoverable and need to write down the net realizable value of the assets.

Under NAS 2, the amount of any write-down of inventories to net realizable value and all losses of inventories shall be recognized as an expense in the period the write-down or loss occurs. Specifically, interim inventory impairment losses should be reflected in the interim period in which they occur, with subsequent recoveries recognized as gains in future periods.

Estimates of net realizable value are to be made based on the most reliable evidence available at that time taking consideration fluctuation of price or cost directly relating to the events occurring after the end of period causing fluctuations. Standard states storage cost to be excluded from the cost of inventories unless those costs are necessary in the production process prior to a further production stage. However, considering the impact of pandemic, relevant storage cost might be exceptionally to be included in inventory cost.

C. FINANCIAL INSTRUMENT

NFRS 9 Financial Instrument sets standard for financial reporting of financial assets and financial liabilities that would present relevant information about the assessment of their amount, timing and uncertainty of an entity's cash flow.

Expected Credit Loss (ECL)

Determination of Expected Credit Loss (ECL) is a complex and significant liability covered by this standard which is based on more of management's judgement and estimation. The standard requires entity to measure ECL in an unbiased way with probability-weighted amount that is determined by evaluating a range of possible outcomes. Management need to determine whether there has been a significant increase in credit risk of a financial asset (or other exposure) since its initial recognition at each reporting date based on estimate of lifetime probability and assessment of forward looking information.

Reductions in the forecasted economic growth increases the probability of default across many individual and corporate borrowers. On the other hand, loss rates may increase due to the fall in value of collateral generally by falls in prices of assets.

C. FINANCIAL INSTRUMENT

Besides banks and other lending business, the ECL effect could be significant to other non-financial corporates as well including bonds and debentures, trade receivables, contract assets, lease receivables, issued loan commitments and issued financial guarantee contracts.

For example, entities calculate their ECL amount for trade receivable based on the weightage average of historical credit losses and expected loss amount in future. But, indirectly operational disruptions have delayed the settlement process experienced by both customers and suppliers which further is fetching potential layoffs and delayed payments. This uncertainty and risk is required to be reflected in the ECL measurement.

In the presence of all uncertainties aroused due to the eventual impact of COVID-19, the relevant estimation and assessment of future has become challenging. Despite the challenges, entities are still required to make estimates based on reasonable and supportable information that is available without undue cost or effort at the reporting date.

C. FINANCIAL INSTRUMENT

Fair Value Measurements

As per NFRS 13, Fair Value Measurements of Financial Instruments should reflect the current market condition with market participant assumptions and market data at the measurement date. Entities will need to pay particularly more attention to fair value measurements based on unobservable inputs (level 3 input) considering the level of volatility and uncertainty in the market due to the impact of COVID-19 pandemic. The current key assumptions of market participants regarding the effect of pandemic, increase in the risk premiums aroused due to uncertainties and major sources of estimations should be sincerely disclosed reflecting at the reporting date.

Classification of Financial Assets

Many banking institutes due to introduction of government's financial relief packages; and restructuring of their existing loans and financing facilities might need to assess if new financial asset or liability or modification gain/ loss is to be recognized. Entities holding assets under "held to collect and sell" or "held to sell" business model may find that previously anticipated sales are no longer viable to take place due liquidity position of market or decline in the asset's price. If any such activity is significant to the entity's operation bringing change in the business model, entities might need to consider reclassifying the financial asset and liabilities.

D. SUBSEQUENT EVENTS

NAS 10 Events after the Balance Sheet Date states that an entity should consider the adjusting and non-adjusting events that have occurred between the end of the reporting period and the date the financial statements are authorized for issue having material impact on the financial statements. Even if management determines after the balance sheet date that entity will be liquidated or ceased voluntarily or involuntarily, entity shall not prepare its financial statements on a going concern basis.

The nationwide lockdown on Nepal was enforced on 11th Chaitra 2076 i.e. 24th March 2020 restricting movements and promoting social distancing. Hence, we can say that the occurrence of COVID-19 event is well within the current Nepalese fiscal year ending 15 July 2020 effects which in the financials are already being perceived and disclosed.

Further, entities now need to evaluate all other significant events that are lined to COVID-19 pandemic arising after end of financial year dated 31 Ashadh 2077 (15 July 2020) considered as adjusting event. Or else, if management concludes those event as a non-adjusting event but the impact of it is material, the entities must disclose the nature of the event and estimate of its financial effect. If reliable estimation of quantitative effect can't be done, there must be a qualitative disclosure including the statement that it is not possible to estimate the effect. An example of adjusting event can be, cancellation of a big customer contract post balance sheet date due to inconvenience caused by pandemic.

Also, if entities receive any government grants with respect to the pandemic, it should also be properly treated in the statements revising the report before publication.

E. INCOME TAX

NAS 12 Income Taxes states that, deferred tax assets shall be recognized for all the deductible temporary differences to the extent that it is probable that taxable profit will be available in future against which temporary difference can be utilized. Temporary differences are determined by reference to the carrying amount of an asset of or liability.

As already described, uncertainties caused by the COVID-19 pandemic have adversely affected the expected future profits of many business entities directly or indirectly. Entities should review the carrying amount of the deferred tax at the end of each reporting period and it should be reduced to the extent that it is no longer probable that sufficient taxable profit will be available to utilize the asset. Deferred tax liability can also be reduced by the asset impairment and create additional deductibles.

As per the standard, deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted by the balance sheet date. But, changes in the entity' expected profits, changes in tax laws, the introduction of relief programs, or changes in the accounting policies that entities might adopt may affect the reversal of deferred tax assets.

Deferred tax assets will also be recognized for the carry forward of tax losses and tax credits to the extent it is probable that future taxable profits will be available against which these losses and credits can be used. Due to the pandemic, entity's estimate to adjust the carried forward losses against future profit, or to use the carried forward tax credits against future taxes may also be affected.

F. LEASES

As per the NAS 17 Leases, any financial leases shall have recognized as assets and liabilities in their balance sheets at the lower of fair value of the leased property or the present value of the minimum lease payments, each determined at the inception of the lease. For the subsequent period, financial charge as well as depreciation should be allocated to each period during lease term at a constant rate of interest in a systematic basis.

Due to the pandemic, it is highly likely that the leased assets might have been impaired. Appling NAS 36 Impairment of assets, the entity now need to determine the recoverable amount of assets and account of impairment loss calculated. Entities also might need to consider changing the accounting estimates regarding useful life of the leased asset.

Moreover, the landlord is entitled to demand rental payments irrespective of whether or not the leased premises are actively used by the tenant. However, currently lessors might loosen up or delay the obligation to pay rents for certain period considering the financial hardship. So, entities should consider reallocation of considerations in the contract, reassessment of lease term, lease liability and lease classification. Financials should be based on revised considerations if it meets the definition of lease modification, maintaining the enough documents as evidence of alteration in lease terms.

It is possible that Nepal government might announces some economic packages and offer compensation to the lessee in future, in such case, the compensation should be accounted under NAS 20 Government grants if the conditions fulfills.

G. REVENUE RECOGNITION

Taxpayers who have filed appeals against tax assessment made up to as per NAS 18 Revenue, revenue is recognized when significant risk and reward has been transferred, no managerial control is retained, the amount of revenue and cost to be incurred related to transaction is measurable and it is probable that economic benefit will flow to the entity associated with the goods agreed to be sold. Similarly, NAS 11 Construction Contract requires regular reassessment of every new and existing contract for the revenue affected by variety of uncertainties that depend on outcome of future events.

The impact brought by COVID-19 pandemic have noticeably affected the expected revenue of many Nepalese industries, mainly tourism industry, transportation industry, hospitality industry, entertainment and other related manufacturing industry. Alongside, Nepalese entities might need to be facing significant uncertainties as to the customer's behavior possibly demanding late payments or some other considerations. Management too may want to help or are obliged to maintain its customers by offering concessions or incentives; or revising the existing contract to extend the payment terms. For instance, entity might be retaining the significant risk and rewards of ownership if goods to be shipped are subject to installation and the installation is a significant part of the contract, but since transportation and availability of workforce is problematic in the current situation, the shipment and installation of good might have been a delayed process altering the revenue recognition period.

So further, the entities should focus revising the contract terms such as work completion time or delivery time, payments terms and estimated cost considering the pandemic situation for the future revenue recognition. Sufficient documents should be maintained for the significant judgements made to revise the contract. If the outcome from transaction cannot be estimated reliably, revenue shall be recognized only to the extent of the expenses recognized that are recoverable as per NAS 18. Additionally, entities now also might need to make proper disclosure clarifying how the pandemic instigated the contract terms to be altered.

H. GOVERNMENT GRANTS

NAS 20 Accounting for Government Grants & Disclosure of Government Assistances states that government grants recognized if there is reasonable assurance that the entity will comply with the conditions attaching to it, and that the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled. Government grants shall be recognized as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis.

Nepal Government, to ease the pandemic outbreak and for financial well-being, have reacted and attempted to support entities affected by giving grants, loans, subsidies or tax reliefs. COVID-19 driven grants are commonly seen in the form of reimbursements of costs for example, with respect of work-from-home order, Government of Nepal has ordered the employers falling under organized sector to continue the payment of remuneration of their employees even if it is in excess of sick leave or annual leave entitlement. For which employers can use the fund deposited into welfare fund. Also, contribution to be made to the Social Security Fund (SSF) for the month of Chaitra (Mid-March to Mid-April 2020) will be made by the SSF itself.

As the reimbursement of payroll cost and SSF'S contribution is within the scope of NAS 20, entities receiving such government assistance should carefully analyze the terms and conditions of the relevant reliefs and recognize them as government grants. It should probably be recognized in profit or loss either separately or under heading "other income" on a systematic basis over the periods in which the entity recognizes the related expenses. Further, the nature and extent of government grant and accounting policy adopted should be concisely disclosed in the financial statement as required by the statement.

Government assistance, such as income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates, that affect the determination of taxable income or the basis of income tax liability may need to be accounted for under NAS 12 Income Taxes.

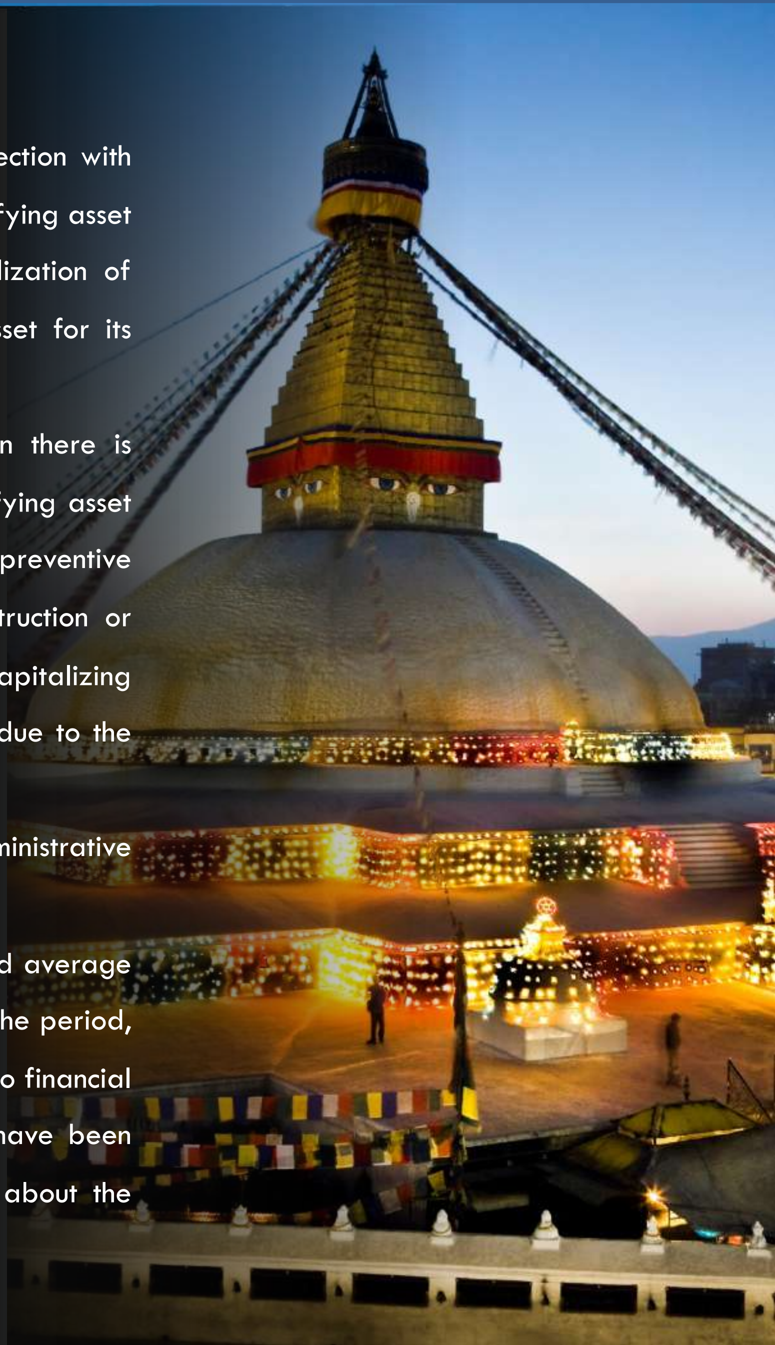
I. BORROWING COSTS

According to the NAS 23 Borrowing Costs, interest or other cost incurred by entity in connection with borrowing of funds directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalized in the financial statement as part of the cost of that asset. Capitalization of borrowing costs shall cease once all the activities necessary to prepare the qualifying asset for its intended use or sale are complete, even though routine administrative work might still continue.

The standard also requires entities to suspend the capitalization of borrowing cost when there is temporarily delay in the completion process of acquiring, construction or production of qualifying asset unless the delay is a necessary part of process. Now, when the nationwide lockdown taken as preventive measure to avoid transmission of the disease has caused entities to postponed any construction or production work, these uncontrollable temporarily delay might still allow entities to continue capitalizing borrowing cost for the specific period. Management must justify that the delay is primarily due to the Covid-19 outbreak.

Management can also continue capitalizing the cost, if it continues to perform substantial administrative or technical work that changes the current condition of qualifying assets.

The borrowing cost to be capitalized is calculated by applying a capitalization rate (weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset). Due to financial distress, negotiations in the borrowing rate as per government relief program also might have been offered requiring entities to reassess the capitalization rate and correspondingly disclose about the change in their statement.



J. IMPAIRMENT

NAS 36 Impairment of Assets states that an asset is impaired when its carrying amount exceeds its recoverable amount. It requires entities to assess the indication of impairment on non-financial assets at each reporting date; and on goodwill and intangible asset at least once in a year. Any external or internal factors affecting the normal course of business might be an indication of asset. This Standard defines recoverable amount as the higher of an asset's or cash generating unit's fair value less costs to sell and its value in use. Estimation of recoverable amount involves the determination of the fair value of assets, forecasting future cash flows, and also the determination of an appropriate discount rate, which involves a certain amount of judgment and estimation.

The impact of pandemic has clued many impairment indications. Shrinkage in the demands have been seen due to adverse economic environment, for example, declining demand rate of crude oil is a flashing news of the month. Many production lines being idle, decreasing exports due to boarder closure and breach of contracts, interruption in the supply chain and loss of customers due to delivery failure or customer's bankruptcy are the common misbehaves noticed in the market. Entities have started witnessing significant negative difference in the expected future cash flow and fair value estimated before and after the COVID-19 impact. The entities with higher leverage ratio might also need to be witnessing bankruptcy.

Entities should now make reasonable and supportable assumptions used in impairment testing and the cash flow forecasts which reflect the potential impact of the COVID-19 based on conditions that existed at the end of the reporting date. The potential material impairment in the assets should be assessed by management making professional judgements with reference to all relevant facts and circumstances. Additional sensitivity analysis is required to be conducted to capture extremely severe downside scenarios where applicable.

K. PROVISION, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

NAS 37 Provision, Contingent Liabilities and Contingent Assets defines provisions as liabilities of uncertain timing or amount, when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and the amount of the obligation can be measured with sufficient reliability. The standard demands management to review the provision at each balance date and adjust it to reflect the current best estimate.

The pandemic has created a situation where all the prior estimations and judgements made by management to book a provision is in a questionable stage. After reassessment if it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed. If decline in the probability or reliability of expected obligation occurs, it shall be disclosed as contingent liability.

This standard further doesn't apply to the executory contracts where both the parties at the inception of contract, excepts to receive a benefit equal to or more than the cost to be incurred under the contract. But, due to the impact of pandemic, parties might incur additional cost exceeding the benefit, then referring it as onerous contract provision can be recognized if the other requirements of standard met.

In case of restructuring provisions which are recognized after a detailed formal plan and a valid expectation by management that those plan will be implemented, there can be changes in this estimation too. As due to the outbreak, entities may carry out restructuring plan that includes closure of certain operations or change its compensation plan.

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