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Some Issues of Preparation and Submission of Financial Statements in the Conditions of COVID - 19

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The coronavirus pandemic has created uncertainties of an unprecedented scale in the global economy. Businesses experience disruptions of supply chain and significant losses. As a result of the decline in business activities, many enterprises around the world have been affected and millions of people have lost their jobs. Significant changes have taken place in the financial and commodity markets as well.

Many governments have taken various measures to provide financial and non-financial assistance to the affected sectors of the economy, businesses and individual enterprises.

All this has somewhat complicated the preparation of financial statements in accordance with the international standards (IFRS).

Against the background of the current uncertainty caused by COVID 19, enterprises need to ensure the preparation of high quality financial statements, which play an important role in the proper functioning of the capital market.

Changes in economic activity have led to the need of revision of the terms of existing contracts and agreements of the enterprises. For example, terms of contracts, leases, and various financial assets and liabilities with customers, as well as asset impairment and changes in the impairment testing assumptions, estimates of expected credit losses for loans and other financial assets, etc.

Changes and uncertainties caused by the pandemics have a significant impact on the estimates of the elements of financial reporting. Nevertheless, each entity must ensure the application of the relevant requirements of IFRS in all of these matters.

The present article highlights some of the challenges posed by pandemic uncertainties in the course of preparation of financial statements.

Keywords: Financial reporting; cash flows; non-financial assets; lease; expenses; inventories.

JEL Codes: E60, E62, P34

Introduction

The statement released by the International Securities and Exchange Commission (IOSCO) on 29 May 2020, on the importance of disclosing information about COVID 19, says: "In conditions of

critically growing uncertainty, it is important for financial reporting to ensure that adequate information is disclosed, the level of transparency of which depends on the firm's judgments and assessments. Disclosure of information should explain the significant impact on specific assets, liabilities, liquidity, solvency and other issues, as well as any significant uncertainties, assumptions, sensitivities, strategies, risks and future prospects. Disclosure of information through financial reporting and management's commentaries is important for raising awareness and confidence of investors. " (IOSCO)

The provision of timely and reliable information by enterprises to its customers remains one of the major challenges of the COVID pandemic.

The impact of the by-pandemic-caused uncertainties on the economy, depends highly on the variables that are difficult to predict.

Each enterprise must assess the current macroeconomic environment, while at the same time enterprises must do their utmost to make sound assessments, prepare comprehensive information in order to determine properly the basis for such assessments, and provide its users with reliable information about the used significant judgments and key assumptions.

At the same time, when reviewing all available information, enterprises should determine whether they have complied with all applicable disclosure requirements envisaged under the International Financial Reporting Standards, including IAS 1 – "Presentation of Financial Statements".

As a result of the impact of COVID-19 and the related events, enterprises should consider whether they can, in certain circumstances, continue to operate for at least 12 months from the reporting date. Management's assessment of the going concern requires professional judgment in the eventual uncertainty of events or conditions at a particular moment, thus ensuring the principle of IAS 1 - "Presentation of Financial Statements" on a going concern.

The clearest example of the increased challenge to forecasting information is testing for impairment of non-financial assets (e.g., fixed assets, usufruct assets, intangible assets, and goodwill). The impairment test for these assets often requires cash flow forecasting. There was a sharp decline in the fair value of many financial assets, especially securities, which in turn also adversely affected the ability of debtors to hedge loan terms and similar financial instruments. Enterprises should consider and apply appropriate assessment and impairment loss recognition requirements.

The decline in the economic activity caused by the pandemic, has put on the agenda the issue of revising the terms of existing contracts and agreements of enterprises, for instance, the terms of contracts with customers, compensation agreements with employees, leases, and many financial assets and liabilities. Enterprises must ensure compliance with the relevant requirements of IFRS.

The purpose of the research is to assess the impact of changes and uncertainties caused by the pandemic on the elements of financial reporting.

The objectives of the research are to reflect adjustments in estimates and assumptions in the preparation of financial statements, taking into account changes and recommendations in the IFRS in relation to the COVID 19 pandemic.

The theoretical and methodological basis of the research is methodological guidelines issued by the International Accounting Standards Board, recommendations materials, works of Georgian and foreign scientists-economists, printed and internet-published materials.

Research Results. The estimates and assumptions used in the preparation of the financial statements in conditions of pandemic should be based on sound judgment and should be adjusted so that they fully reflect the new business environment and at the same time comply with IFRS requirements.

This article deals with only the basic requirements and guidelines for the following aspects of financial reporting: substantive judgment and assessments, measuring impairment of non-financial assets, lease.

Substantive Judgment and Assessments

In preparing the annual financial statements, management makes a number of judgments, assessments and assumptions about the recognition and measurement of assets, liabilities, incomes and expenses. The outbreak of the pandemic and further economic crisis have had a direct impact on many areas of financial reporting of companies. In the conditions of uncertainty, it is especially important to measure them accurately and reflect the impact of existing situations in the financial statements. The estimates and assumptions used in the annual financial statements should be adjusted in such a way that they fully reflect the new business environment and at the same time comply with IFRS requirements.

To make assessments entities should review all information available to them and also determine whether they have complied with all applicable requirements for its disclosure, including IAS 1 – Presentation of Financial Statements. The enterprises, must make optimal decisions regarding assumptions and reliable assessments on the one hand, and must comply fully with the requirements of International Financial Reporting Standards, on the one hand.

Existing and potential investors make investment-related decisions based on the published financial statements. In such a situation, information about how the pandemic and related uncertainties affect the enterprise and what the impact of the pandemic crisis will be on the financial state, is of particular importance to them.

Investment decisions are based on the information about future cash flows, which means that in financial statements, users should be able to understand current and past results and form an opinion about future cash flows.

The unprecedented closure of the global economy has led to the fact that a number of companies are unable to sell and supply their products and services to consumers. Delays in the production process as well as in supply chain, have led to a reduction in consumption (demand). In such a situation, the management must determine first of all, whether the assumption about “going concern” is valid. (Ernst & Young)

When measuring the going concern under the coronavirus pandemic, its obvious and probable impact on the company's operations should be taken into account. Current events and conditions can significantly affect the ability of an enterprise to continue operating. Clearly, the impact of the pandemic is more significant for high-risk sector companies experiencing low demand, low sales, and low margin pressures (Sabauri L, Kvatashidze N. 277)

In assessing the likelihood of continuing operations, management should consider all available information obtained after the end of the reporting period, including information on measures taken by governments and banks for assisting affected organizations.

In order for the financial statements to adequately reflect the future uncertainties of the business environment, great importance is given to the professional argumentation on preparation of financial statements and of interested parties, as well as those responsible for the presentation of financial statements. Such reasoning, especially in the context of a pandemic, should be applied to issues such as the net realizable value of inventories, impairment of receivables, property, plant and equipment and intangible assets, as well as issues of contractual obligations, recognition of income and expenses, etc.

The methodology for reflecting the impact of the pandemic on financial reporting has been somewhat developed and reflected in current editions of International Financial Reporting Standards, although due to the circumstances specific to particular enterprises, it is necessary to have a professional judgment on a variety of substantive issues. In this case, special care should be taken, as overestimation of revenues and assets, as well as the amount of inventory created, may lead to an unreasonable increase or decrease of a consumer's interest.

Such professional reasoning should be fully disclosed in accordance with IAS 1 – Presentation of Financial Statements.

Measurement of Inventories

As a result of the pandemic, some enterprises were forced to reconsider their methods of conducting the business operations. For example the ways of delivering goods and services, has changed or moved to e-commerce. It is likely that these changes may increase costs and affect the inventory value.

The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.

Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration.

Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance.

The COVID-19 pandemic can have multiple impacts on manufacturing capacity, such as creating labor and material shortages, which can lead to abnormal declines in production.

Manufacturing entities may revise the practice of allocating fixed overhead costs if production volume decreases abnormally during the year due to plant closures or reduced demand for their products.

IAS 2 – “Inventories” requires variable overhead costs to be allocated to a unit of output based on their actual cost. It also requires the distribution of the fixed production overheads c per unit of production, based on the average production capacity.

If the production volume is below average, enterprises should not increase the fixed (permanent) overhead costs attributable to the unit of output, and vice versa, , unallocated overheads should be recognized as an expense in the period in which they arise.

At the same time, the level of production of some goods, due to excessive demand, may be abnormally high. In such cases, the entity shall reduce the amount of the fixed overhead costs per unit issue so that inventories are not overstated.

The enterprise should also consider whether it is possible to capitalize certain costs incurred due to the pandemic that the enterprise would not otherwise have incurred. This may involve the additional cost of storing or repackaging stocks to make the product available in another, higher demand market. As such costs are not capitalized under IAS 2, an entity may capitalize such costs based on its own

judgment, taking in mind the existing situation. In such circumstances, the enterprise is required to disclose this information in the explanatory notes to the financial statements. (Ernst & Young)

In accordance with IAS 2, inventories are valued at the lower of their cost and net realizable value.

Net realizable value refers to the net amount that an entity expects to realize from the sale of inventory in the ordinary course of business, less the costs to finish and sell of the goods. As mentioned above, the costs required to finish the goods or the expected costs of selling thereof, may change. In addition, during a pandemic and especially during a severe lockout period, user behavior may change. For example, during a period of agitation, demand for certain types of products may increase significantly, and then demand may fall again or not disappear at all. It is also possible for companies to be forced to apply for discounts on their products in order to attract buyers. These changes may lead to volatility in selling prices, which in turn will affect the net realizable value.

As long as uncertainty persists, the estimated net realizable value may be subject to greater uncertainty than in the past, so, significant reasoning may be required to make appropriate assumptions. In some cases, enterprises may be forced to write off their inventories. For example, enterprises that produce perishable goods may be forced to utilize the goods they have not been able to store or sell. Other entities may need to determine whether inventories should be written off to the net realizable value in the event of total or partial depreciation or a decrease in their selling price.

Disclosure of the inventory-related information, including cost formulas used, helps users to understand how transactions, events and conditions are reflected in their financial statements. The entities are required, at least, to disclose the cost of inventory recognized as an expense in a given reporting period. In addition, entities should disclose information regarding the circumstances or events that caused inventories to be written off.

The decisions made in response to the pandemic may lead to re-measurement of inventories by entities. A decrease in demand may lead to a write-off the inventories to net realizable value, and the determination of net realizable value may require significant judgment. Entities should carefully consider the need to disclose additional information to help financial reporting users to understand the impact of the pandemic on inventories.

Measurement of Impairment of Non-Financial Assets

An asset is deemed impaired when its carrying amount exceeds its recoverable amount. For the impairment testing purposes, an entity shall measure the recoverable amount, which is the fair value less costs to sell and the value in use. Value in use is the present value of future cash flows the entity expects to derive from the asset or cash-generating units. Calculating the value in use of an asset is an estimate of the amount and timing of future cash flows expected from an asset.

IAS 36 "Impairment of Assets" requires that an entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired, while for goodwill or intangible assets with indefinite useful lives, the Standard requires impairment testing on yearly basis, or when any indication that an asset may be impaired, exists. .

Entities should also measure for indications of impairment for other classes of assets within the Standard. An impairment test is performed only when such indications exist. In addition, post-reporting events and information received after the end of the reporting period should be considered only if there are any indications of impairment that provide additional evidence of conditions at the end of the reporting period.

Similarly, in determining the recoverable amount of an asset, information received after the end of the reporting period should be taken into account only if such information relates to circumstances at the end of the reporting period. However, it requires judgment in the light of all the facts and circumstances.

As noted above, at the end of each reporting period, for all assets under IAS 36, an entity measures whether there is any indication that the assets are impaired. Given the development of the pandemic, there are both external and internal sources of information that indicate possible impairment of assets, such as: falling stock and commodity prices, falling market interest rates, shutdown of enterprises, closure of stores, low demand and prices for goods and services, etc. (IAS 36)

Enterprises should also consider the need to update measurements to ensure that the most relevant facts and circumstances are reflected.

In addition, IAS 36 requires entities to determine at the end of each reporting period whether there is any indication that an impairment loss may no longer exist or be reduced in respect of all assets except goodwill. If any such indication exists, the enterprise shall re-measure the recoverable amount of the asset. At the same time, the Standard provides examples of indications of possible reduction in impairment losses that are, in fact, “opposite” to the indications of impairment.

When measuring impairment, enterprises may need to make significant judgments as to whether they meet the requirements of IAS 36, using the most recent detailed measurement of the recoverable amount established during the impairment test. Since it is likely that in the current situation, many enterprises will not be able to meet these requirements, in making this decision, it may be useful to disclose additional information to support it.

Fair value less costs to sell are based on the provisions of IFRS 13 “Fair Value Measurement”

Measurement of cost in use includes:

-) Measurement of future cash flows from the continued use of the asset and its disposal; and
-) Application of the appropriate discount rate to future cash flows.

The future cash flows should reflect the best measurement of the remaining useful life of the asset at the end of the reporting period. In such circumstances, when measuring the value in use, we think it is more appropriate to use the expected cash flow method that is based on weighted probability rather than the one-time best measurement method.

„This approach is based on assumption that all the possible outcomes of the future cash flows and the added risk may be combined with one agreed discount rate“. (Vardiashvili 2019, 524)

Since many assets may have a long useful life remaining, enterprises need to consider not only the short-term effects of the pandemic but also its long-term impact. In any situation, „in determining the value in use of the asset, the emphasis should be made on the best assessment of the expected economic situation during the remaining useful service life of the given asset.

(Vardiashvili 2019, 524) For example, if an enterprise intends to withdraw its fixed assets from service in the future, it will have to adjust the amortization period and write off the carrying amount of that asset to its residual value, if any.

As the crisis continues and it is impossible to predict further conditions, at this stage, in order to test for impairment, management should use substantial judgment to confirm reasonable assumptions that clearly reflect the circumstances as of the reporting date.

It is likely that most of these assumptions are subject to considerable uncertainty. Therefore, enterprises should consider disclosing details of assumptions and sensitivities.

The greater the uncertainty in the circumstances, the more important it is for entities to disclose information in detail.

Given the high degree of uncertainty in judgments and measurements, special importance is given to disclosing the key assumptions and considerations obtained in measuring the amount to be reimbursed. (Ernst & Young) This is especially true as they are likely to be substantially updated from the key assumptions, judgments and measurements used in the most recent annual financial statements.

Changes in Lease

On 28 May 2020, the IASB released amendments to IFRS 16 – “Leases, COVID-19-related rent concession”. The Board introduced these amendments to exempt tenants from applying the IFRS 16 requirements and to take into account lease changes in the event of the rent concession, which are the direct result of a pandemic. For example, halving the rent on the grounds that the leased asset does not work at its full capacity, or works with delays. This change does not apply to lessees. (IFRS 16)

In granting this exemption, the Board acknowledged that lessees may find it difficult to measure whether a lease is a modification of a pandemic lease, and if so, it would be difficult to apply the IFRS 16 requirements to a lease, especially since lessees face many challenges during the pandemic.

The purpose of the amendment is to offer a more streamlined practical approach to lessees when concede lease due to COVID 19 their Covid-19 lease.

According to the simplified approach, the lessee has the right not to analyze whether the lease made by the lessor due to a COVID pandemic is a modification of the lease.

When making this decision, the lessee shall account for any change in the lease resulting from such a lease, using the same method as reflecting that change in accordance with this Standard, unless the change were a modification of the lease.

The lessee may apply these practical approaches to contracts with similar characteristics and in similar circumstances.

The simplified approach set out in the amendments applies only to such rental concessions that arise as a direct result of the COVID- 19 pandemic and only if all of the following conditions are met:

-) A change in rent payments results in a change / revision of the amount of rent, but the adjusted amount of the rent is essentially the same or less than the amount of the rent that was directly before the change in the amount of rent occurred;
-) Reduction of rent payments applies only to payments that were payable under the original agreement no later than June 30, 2022 (e.g. concession of lease will meet this condition if as a result of concession, the rents paid as at or before 30 June, 2022, are reduced, while the rents to be after 30 June 2022, are increased); and
-) No other significant changes have been made to the terms and conditions of the lease. (Proposed amendment to IFRS 16)

Regarding the changes, “The Board concluded that concession of the lease resulting in an increase in the total amount of rent should not be considered a direct result of the COVID 19 pandemic, unless this increase reflects the time value of money”.

Therefore, leasing, which takes into account deferred rents and their increase due to the time value of money, is subject to a simplified approach, if all other conditions are met.

The IASB also clarified that qualitative and quantitative factors must be taken into account to measure significant changes in lease terms. The existence of other significant changes, other than the concession associated with the COVID-19 pandemic, means that the lease modification as a whole is not consistent with the use of a simplified approach.

According to IFRS 16, a lessee shall apply this document – “Lease Concession due to COVID 19” with full retrospective effect, so that to recognize the cumulative effect of initial application of this amendment as adjustment of the opening balance of undistributed profit (or any other component of equity, if necessary) at the beginning of the reporting period in which the lessee first applies the amendment.

In addition to the above, uncertainties related to the COVID 19 pandemic and current market conditions may also lead to changes in consumer contracts (Vardiashvili M, Maisuradze M. 2022,123). Undertakings shall record the modification of the contract in accordance with the requirements of IFRS 15, which provides for some modifications to be recorded as separate contracts, while others may become part of the original contract and be recorded as a single contract. In addition, some modifications are considered prospectively, while others are considered using a cumulative approach (Vardiashvili M, Maisuradze M. 2022,123).

Conclusion

Uncertainties on an unprecedented scale caused by the pandemic have somewhat complicated preparation of financial reporting in compliance with the international standards.

Changes in the economic activity have led to the need of revision of the terms and conditions of existing contracts and agreements of enterprises. International Financial Accounting Standards Authorities have made a number of changes to IFRSs to address the uncertainties caused by the COVID 19 pandemic.

In cases of disruption of the production process and the supply chain, management must first determine whether the assumption applies to a “going concern”. When measuring the possibility of continuing operations, information should be provided on measures taken by governments and banks to assist affected enterprises. Enterprises should include additional items of financial reporting elements in the explanatory notes to the financial statements, including quantitative or qualitative explanations as a result of the pandemic.

Thus, enterprises can use different ways to present information about the impact of the pandemic on their financial results, financial conditions and cash flows. However, it will certainly be difficult to fully account for the individual impact caused by the pandemic and the consequences of state support measures.

The cost of inventories can be significantly affected by changes in both enterprise operations and customer demand.

As a result of the pandemic, changes in the methods of delivery and sale of goods may lead to generation of costs such as the cost of additional storage or repackaging when supplies are delayed, in order to make the goods available in other high-demand markets. In generating such costs, enterprises should consider whether it is possible to capitalize certain costs incurred due to the pandemic.

In accordance with IAS 2, inventories are valued at the lower of their cost and net realizable value. Decisions made in response to a pandemic may necessitate a re-measurement of inventories by units. A decrease in demand may lead to a write-off the inventories to net realizable value, and the determination of net realizable value may require significant judgment. Businesses should carefully

consider the need to disclose additional information to help financial reporting users understand the impact of a pandemic on inventories.

IAS 36 "Impairment of Assets" requires that an entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired, while for goodwill or intangible assets with indefinite useful lives, the Standard requires impairment testing on yearly basis, or when any indication that an asset may be impaired, exists.

Entities should also measure for indications of impairment for other classes of assets within the Standard. An asset is considered impaired when the carrying amount of the asset exceeds its recoverable amount.

The measurement of value in use includes the estimate of the continuing use of the asset and the future cash flows from its sale and the present value of those cash flows.

Since many assets may have a long remaining useful life enterprises should consider not only the short-term effects of the pandemic but also its long-term impact, when making their measurement.

At this stage, in order to test for impairment, management should use substantial judgment to establish reasonable assumptions that reflect the circumstances as of the reporting date. It is likely that most of these assumptions are subject to considerable uncertainty. Therefore, enterprises should consider disclosing the details of reasonable assumptions.

According to the amendment to IFRS 16, that was published by the Board, the rent concessions shall apply to lessees. They should take into account lease changes in the event of lease discounts arising from a direct result of a pandemic. This change does not apply to lessors. The purpose of the amendment is to offer lessees a simplified approach of a practical nature in case of concession the Covid-19-related lease. The simplified approach provides that the lessee has the right not to analyze whether concession made by the lessor due to a pandemic, is a modification of the lease.

Qualitative and quantitative factors must be taken into account to assess significant changes in lease terms. The existence of other significant changes, other than the concession associated with the Covid 19 pandemic, means that the lease modification as a whole is not consistent with the use of a simplified approach.

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