Asking The Right Questions - Reviewing Financial Statements and Selecting Auditors in the Covid-19 Era

The COVID-19 pandemic has created market volatilities and economic uncertainties that may raise accounting and valuation issues for companies. To ensure that financial statements continue to give a true and fair view, and are compliant with the accounting standards, Audit Committees (ACs) need to exercise greater due diligence, said experts from the Accounting and Corporate Regulatory Authority of Singapore (ACRA) and the Institute of Valuers and Appraisers, Singapore (IVAS), at a recent session of the Singapore Institute of Directors' AC Chapter Pit-Stop Series, themed "Asking The Right Questions – Reviewing Financial Statements and Selecting Auditors".

Potential Accounting Issues

With the outlook of the Singapore economy continuing to weaken, directors should probe more deeply into several accounting issues that may arise, said Ms Tan Wee Khim, a Principal Compliance Manager in ACRA's Financial Reporting Surveillance Department. She cited the following potential accounting issues:

1. If a company has changed its business model, for instance changing from physical sales to online sales, its directors should ensure that forecasted cash flows reflect the latest business model. Both the forecasted cash flows and discount rate should also be updated to account for the higher risks in a poor performing or uncertain economy.

2. For investment properties and other non-current assets held at fair value, there could be restrictions to the valuers' work, such as inability to conduct on-site visits due to travel restrictions. As a result, valuers will need to rely on the information provided by the management and directors should ensure that adequate and accurate information are provided.

3. When it comes to financial instruments, directors should relook into the economic viability and the fair value of contracts given recent market upheavals, reassess whether hedge accounting is still effective, and tailor financial risk management disclosures to actual circumstances instead of using boilerplates.

4. In assessing the collectability of trade receivables, other receivables and contract assets, directors may no longer be able to rely on normal ageing and historical repayment profiles. Instead, directors should consider other risk factors such as how the industry and/or geographical regions, where the company operates in, have been affected by the pandemic.

5. There may be events or conditions that exist at year-end that may cast significant doubt on a company's ability to continue as a going concern, such as defaults on loans, denial of usual trade credit from suppliers, legal proceedings and loss of principal customers. If there are material uncertainties, directors should ensure these are disclosed. If critical judgement is made in arriving at the conclusion that there are no material uncertainties, directors should disclose that judgement as well.

Updating Valuation Approaches

Mr Lie Kok Keong, Chairman of IVAS Standards and Technical Committee and a Valuation Leader in PwC Singapore said that valuation approaches may need to be adjusted as the pandemic has changed valuations. He cited some ways the pandemic has changed valuations:

1. Some industries, such as construction, may experience a short-term dip in performance, while others, such as those providing digital tools and healthcare, may flourish. Some sectors, including air travel and tourism, are likely to face longer-term disruption.

2. Beyond the heightened risk of going into administration, the overall cost of capital is likely to be higher for businesses. The huge volatility in market prices, which reflect the ongoing uncertainties in the economy, may also render market approach valuations problematic.

Mr Lie suggested some ways to adjust valuations:

1. “When you use an income approach for valuation which involves predictions of future cash flows, you should reconsider the use of any single set of cash flows. Our recommendation would be to investigate multiple probability-weighted scenarios for different cash flows.”

2. “You may also want to consider a specific risk premium for the discount rate on top of the normal discount rate, or make an adjustment to the cash flow to reflect the higher risks in the economy now, although not both because of double-counting.”

3. “Given that we have observed wide swings in valuation multiples during the recent period of volatility, relying solely on market observed valuation multiples for unquoted instruments may not provide enough rigour to valuation analyses. When market multiples may not reflect value drivers for an unquoted instrument, management should consider multiple valuation approaches, such as including income approach valuations.”

Mr Lie advised that while a firm’s management is typically in the best position to quantify the impact of the pandemic on its cash flows, directors who are unsure about the management’s ability to do so, or who require additional comfort, should seek the help of external valuers or experts.

Mr Lie stressed: “An increased amount of diligence and scrutiny may be required when assessing forecasts over the next six to 18 months. It is important to understand how each component of the business is being affected by the pandemic, the level of preparedness, and any crisis plan that is or will be implemented.”