

April 22nd, 2020

To our members

The Japanese Institute of Certified Public Accountants

Audit Considerations related to COVID-19 (Part 4)

JICPA has been issuing a series of notes titled “Audit Considerations related to COVID-19” and as “Part 4” has put together as below audit considerations to address the following two matters raised frequently by our members.

- 1 . Accounting treatment of fixed costs where companies have suspended their businesses in response to requests from the central or local governments or for similar reasons.
- 2 . Considerations for banks and other financial institutions regarding allowance for credit losses

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1. Accounting treatment of fixed costs during operation / business suspension

If audited companies suspended their businesses in response to the requests from the central or local governments or for similar reasons in order to prevent further spread of COVID-19, items such as (i) fixed cost during business suspension, and (ii) the exogenous impact to costs caused by extraordinary decline of factory operation rate could meet the requirements of ‘extraordinary loss’ in the income statement.

However, the auditor needs to pay attention so that losses due to poor performance or other reasons caused in the course of normal business activities, not caused by suspension of their business in accordance with requests from the central or local governments or for similar reasons in order to prevent further spread of COVID-19, should not be recorded as ‘extraordinary loss’.

(Treatment of ‘extraordinary loss’ under the Japanese GAAP)

It is required to present profit and loss in a phased manner on the face of income statement under Japanese GAAP. In this regard, unlike IFRSs or US-GAAP, Japanese GAAP requires unusual or infrequent occurring items to be presented on the face of income statement under the heading of “extraordinary income (loss)”

2. Considerations for banks and other financial institutions regarding allowance for credit losses

The calculation of allowance of credit losses for banks and other financial institutions requires estimation (i.e., making accounting estimate that is reasonable based on information available at the time of preparation of financial statements) that involves management judgement. The auditor is required to evaluate whether accounting estimates made by the management are reasonable and related disclosures are adequate. This also applies when banks and other financial institutions make necessary revisions to their original projections such as future credit losses and necessary adjustments to the historical default rates used in the allowance calculation of doubtful accounts considering the exogenous impact caused by COVID-19.

On April 10, 2020, the Accounting Standards Board of Japan released “Summary of the Discussions at the 429th Board meeting Held on April 9, 2020 (Incorporating the Effects of the Novel Coronavirus Pandemic when Making Accounting Estimates under Japanese GAAP)”. On the same date, JICPA issued a note titled “Audit Consideration related to COVID-19 (Part 2)” that is based on the ASBJ’s Summary of the Discussions.

The auditor needs to pay attention to the release and the note as references in auditing the estimation of the allowance for credit losses of banks and other financial institutions. The auditor is also required to evaluate whether the financial statements appropriately and sufficiently disclose accounting policies selected and applied for the allowance for credit losses in an understandable manner for financial statement users.

In addition, the auditor should be mindful that in the Emergency Economic Package adopted by the Cabinet on April 20, 2020, the Government noted “Judgment made by the private financial institution with regard to each individual asset assessment, such as the classification of loan claims in the event of modifications to loan repayment periods, shall be respected and will not be individually denied in inspections by the regulatory authority.”

It should be noted that the auditor needs to confirm whether risk management for loan exposures (in particular, loans with modified lending terms and conditions) are treated adequately under the Assessment Standards for Banks and other financial institutions and the Ordinance for Enforcement of the Banking Act, etc., taking into account the Emergency Economic Package.