

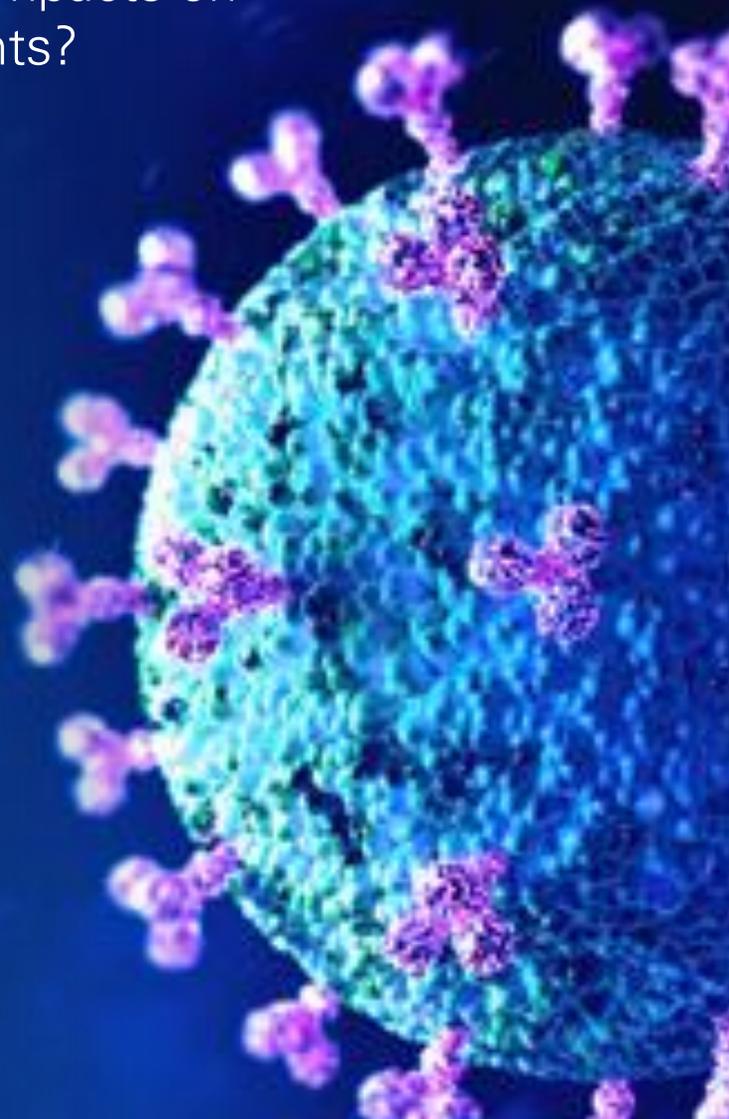


COVID-19 Financial Reporting Implications

What are the key impacts on
financial instruments?

Part 03

KPMG in Sri Lanka



Content

The World Health Organisation has declared the COVID-19 coronavirus outbreak to be a pandemic. Since March 20, many governments are taking stringent steps to contain and/or delay the spread of the virus.

Actions taken in response to the spread of COVID-19 have resulted in significant disruption to business operations and a significant increase in economic uncertainty, with more volatile asset prices and currency exchange rates, and a marked decline in long-term interest rates in developed economies.

These events and conditions create a level of uncertainty and risk that companies may not have encountered before, and may result in significant financial reporting implications for preparers of financial statements. KPMG focuses on the potential financial reporting impacts for 2020 period ends.

The KPMG Team has put together this summary which we believe, can help you better understand the potentially significant accounting and disclosure implications for your company, and the actions management needs to take now.

The following sections are covered in this Guidance:

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01. How have the economic forecasts used to measure expected credit losses been updated?

ECL measurements need to incorporate forward-looking information that is available without undue cost or effort at the reporting date. This may be particularly challenging to do for the economic impact of COVID-19.



The COVID-19 coronavirus outbreak is already having severe economic impacts across many jurisdictions compared with 31 December 2019. The economic shocks may become more severe and spread to other jurisdictions. Many governments, central banks and economists have been revising their economic forecasts to try to capture the likely impacts. However, the economic outlook is highly uncertain and may change quickly.

Companies are required to update the economic forecasts that they use to measure ECLs at each reporting date by incorporating the reasonable and supportable information available at that time. The effort and sophistication required will depend on the company's exposures. ECLs are usually material for banks and other financial institutions and these companies are likely to face the greatest challenges and will need to put the most resources into updating ECLs to reflect changing conditions.

The following factors may be particularly relevant when measuring ECLs.

- The increased uncertainty about potential future economic scenarios and their impact on credit losses may require companies to explicitly consider additional economic scenarios when measuring ECLs.
- Existing ECL models will use historical experience to derive links between changes in economic conditions and customer behaviour, and ECL parameters such as loss rates, probabilities of default and loss given default. However, these historical relationships are unlikely to read across to the COVID-19 pandemic. Therefore, adjustments to model results, based on expert credit judgement (eg; increasing weightage allocated to the Worst case scenario in the models), could be necessary to reflect the information available at the reporting date appropriately.
- If the effects of covid-19 cannot be reflected in models, post-model overlays or adjustments will need to be considered. The environment is subject to rapid change and updated facts and circumstances should continue to be monitored as new information becomes available.
- Certain types of customers, industries or regions may be particularly severely affected by the economic effects of COVID-19. Companies with exposure to these customers, industries or regions will need to consider whether this is appropriately captured in their ECL measurements.
- Government and Central Bank are launching measures to mitigate the adverse impact of COVID-19 on borrowers. Companies may need to consider this when estimating ECLs.
- Many borrowers are drawing down credit lines or holding on to cash to obtain additional liquidity to help them weather the economic storms. This will be relevant for estimating exposures from loan commitments and pre-payable or extendable loans.
- The expected cash flows used in measuring ECLs may also be affected by any actions planned by the company (e.g. modification, forbearance, limit extensions).

Measurement of ECLs



Disclosures

A company is required to disclose the nature and extent of risks arising from financial instruments and how it manages those risks. Therefore, a company will need to explain the significant impacts of COVID-19 on the risks arising from financial instruments and how it is managing those risks. It will need to use judgement to determine the specific disclosures that are relevant to its business and necessary to meet these objectives.

Examples of specific disclosures include the following.

- Information about a company's credit risk management practices and how they relate to the recognition and measurement of ECLs. A company may have changed its risk management practices in response to COVID-19 – e.g. by extending debt relief to borrowers or by following specific guidance issued by government or regulators.
- The methods, assumptions and information used to measure ECLs – e.g. a company may need to explain how it has incorporated updated forward-looking information into measuring ECLs, in particular:
 - ✓ how it has dealt with the challenge of ECL models that were not designed for the current economic shocks; and
 - ✓ how it has calculated overlays and adjustments to these models.
- Quantitative and qualitative information that allows evaluation of the amounts arising from ECLs; the types of analysis disclosed previously may need to be adjusted or supplemented to clearly convey impacts arising from COVID-19.
- Information on the assumptions that the company has made about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in material adjustment within the next financial year.



Actions for Management to take NOW

Consider the following when measuring ECL:

- whether adjustments to model results, based on expert credit judgement, are necessary (adjustments to forward looking economic factors, weightage allocated to worst case scenarios in the model) ;
- If the effects of covid-19 cannot be reflected in models, whether post-model overlays or adjustments will need to be considered. The environment is subject to rapid change and updated facts and circumstances should continue to be monitored as new information becomes available.
- whether the measurement appropriately captures the types of customers/issuers or regions that are particularly impacted by the economic effects of COVID-19;
- changes in customer behaviour such as drawing more extensively on credit lines and holding on to cash;
- the impact of any assistance to borrowers from a government or regulator; and
- the impact of any actions planned by the company (e.g. modification, forbearance, limit increases) on the expected cash flows

02. How has the credit risk of borrowers and other debtors been reassessed?

Companies are required to incorporate forward-looking information that is available without undue cost or effort into their assessment of whether credit risk on a financial instrument has increased significantly. This may be particularly challenging to do for the economic impact of COVID-19.



Identifying significant increases in credit risk and credit impairment

Identifying Significant Increase in Credit Risk (SICR) is usually material for banks and other financial institutions. Many banks calculate explicit probabilities of default (PDs) for individual exposures and use these to perform quantitative assessments of SICR.

They will need to consider whether they can incorporate COVID-19-related changes in the risk of default into PDs for *individual exposures* on a timely basis.

Companies also need to consider qualitative factors when identifying SICR. For example, changes in customer behaviour or requests for payment holidays or credit limit increases may indicate SICR or credit impairment.

If a company is not able to identify key drivers of credit risk on an individual instrument basis, then it may need to assess SICR on a collective basis.

Government assistance provided directly to borrowers might reduce the probability of a borrower defaulting and so avoid SICR occurring in some cases. Consideration also need to be given on whether the concessions under moratoriums could enable certain borrowers to resume regular payments in the foreseeable future (whom otherwise would have fallen into financial difficulty), such that significant increase in credit risk would not occur over expected remaining lives of the receivables.

The extension of payment holidays to all borrowers in particular classes of financial instruments shall not automatically result in all those instruments being considered to have suffered SICR. Consideration also need to be given on whether the concessions under moratoriums could enable certain borrowers to resume regular payments in the foreseeable future (whom otherwise would have fallen into financial difficulty), such that significant increase in credit risk would not occur over expected remaining lives of the receivables.



Sovereign exposures

Companies with exposures to governments, including investments in sovereign bonds, will need to update their measurements of ECLs and assessments of whether there is a significant increase in credit risk. COVID-19 is putting pressure on government finances and the pressure may become more intense over the coming months – this may impact the assessment of sovereign credit risk.

The likelihood of SICR occurring in the near future will be elevated for sovereign exposures that are at the lower end of the investment grade rating range with a negative outlook.



Modifications and forbearance

As borrowers face greater risk of financial stress from the consequences of COVID-19, they might approach lenders to ask for concessions against the current terms of their borrowings.

For example, they might request relaxation of covenants, delayed repayment of interest or principal, or a reduction in the interest rate. Governments might encourage banks to provide concessions for particular types of customers.

Both lenders and borrowers will need to analyse any such arrangements carefully to determine the appropriate accounting – i.e. they will need to assess whether:

- there has been a change in the contractual terms of a financial instrument and, if so, whether it leads to a derecognition gain or loss, or a remeasurement of its amortised cost; and
- for the lender, the arrangement indicates SICR or a credit impairment, or results in a partial write-off of the loan.

If a government provides assistance to a lender and this in turn enables the lender to provide support to its customers, then the lender will need to consider how to account for that assistance – in particular, whether government grant accounting under LKAS 20 Accounting for Government Grants and Disclosure of Government Assistance is required.



Disclosures

A company is required to disclose the nature and extent of risks arising from financial instruments and how it manages those risks. Therefore, a company will need to explain the significant impacts of COVID-19 on the risks arising from financial instruments and on how it is managing those risks. It will need to use judgement to determine the specific disclosures that are relevant to its business and necessary to meet these objectives.

Examples of specific disclosures include the following.

- How management determined whether the credit risk of the financial instrument has increased significantly since initial recognition. The methods and indicators used may have changed in response to the current conditions – e.g. additional collective assessments may have been performed or financial instruments may have been grouped differently.
- The methods, assumptions and information used to assess SICR – e.g. a company may need to explain how it has incorporated updated forward-looking information into assessing SICR.
- Quantitative and qualitative information that allows evaluation of the amounts arising from ECLs. The types of analysis disclosed previously may need to be adjusted or supplemented to clearly convey impacts arising from COVID-19.
- Information on the assumptions that the company has made about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in a material adjustment within the next financial year.



Actions for Management to take NOW

Consider:

- whether it is possible to incorporate COVID-19-related changes in the risk of default into PDs for individual exposures on a timely basis;
- incorporating qualitative factors in identifying SICR – e.g. changes in customer behaviour or requests for payment holidays or limit increases;
- assessing SICR on a collective basis;
- whether modification of contractual terms of a financial instrument leads to recognising a gain or loss on derecognition, or a gain or loss on remeasurement; and
- whether assistance provided by a government means that government grant accounting is appropriate.

03. Are fair values appropriately determined?

The fair value of an asset (or liability) should reflect market conditions at the measurement date. This has become more challenging due to the uncertainty of the economic impact of COVID-19.



Reflecting risks and market conditions at the measurement date

Some of the key factors and risks to consider when measuring fair value using a valuation technique include the following.

- **Economic activity levels** - Measures taken to contain the virus may lead to a significant reduction in economic activity in terms of production of and demand for goods and services, and may have a negative impact on forecast future cash flows used in a discounted cash flow valuation method.
- **Credit risk and liquidity risk** - The uncertain economic environment has resulted in increases in credit risk and liquidity risk for many companies. Own credit risk and/or counterparty credit risk used as inputs into valuation techniques may therefore increase.
- **Forecasting risk** - Fair value measurements should reflect the greater uncertainty in making economic and financial forecasts in the near term, due to the difficulty in forecasting the magnitude and duration of the economic impact of COVID-19.
- **Foreign exchange risk** - Companies with significant sales or purchases in foreign currencies may be adversely affected by exchange rate movements.
- **Commodity price risk** - Companies in extractive industries may be significantly affected by decreases in commodity prices. Companies in countries that are economically dependent on these commodities may also have greater risk of adverse economic impacts.

Significant judgment may be needed to quantify risk premiums and other adjustments for these risks. Also, the number of fair value measurements classified as Level 3 in the fair value hierarchy may increase (e.g. due to unobservable inputs such as the credit risk becoming significant in the current environment).



Disclosures : Interim Reporting

- Sensitivity disclosures and significant transfers between levels in the fair value hierarchy.
- Fair value disclosures related to non-financial assets and non-financial liabilities are required if they are material to an understanding of the current interim period. This may be the case when fair values change significantly.



**Disclosures :
Annual
Report**

- Sensitivity disclosures – together with disclosure of the key assumptions and judgements made by management – to enable users to understand how fair value has been determined.
- Specific disclosure are required when amounts are transferred into Level 3 of the fair value hierarchy, including sensitivity disclosures.



Actions for Management to take NOW

- Consider whether the valuation:
 - ✓ reflects market participants' assumptions based on information available and market conditions at the measurement date; and
 - ✓ incorporates the risk premiums that would arise from the increased uncertainty and other impacts of COVID-19.
- Consider whether unobservable inputs have become significant, which would result in a Level 3 categorisation and require additional disclosures.
- Consider expanding disclosures about the key assumptions, sensitivities and major sources of estimation uncertainty.

04. How is hedge accounting impacted?

The COVID-19 outbreak may affect when and how a company applies hedge accounting.



Changes to hedged transactions

The COVID-19 outbreak is causing reductions in actual and forecast volumes of transactions in many regions and industries. If the COVID-19 outbreak reduces the probability of a hedged forecast transaction occurring or affects its timing, then the hedge accounting relationship may need to be terminated or there may be hedge ineffectiveness.

Similarly, a reduction in the volume of highly probable forecast transactions may lead to partial termination under SLFRS 9.

When a hedging relationship is discontinued because a forecast transaction is no longer highly probable, a company needs to determine whether the transaction is still expected to occur.

If the transaction is still expected to occur, then gains or losses on the hedging instrument previously accumulated in the cash flow reserve would generally remain there until the future cash flows occur; or no longer expected to occur, then the accumulated gains or losses on the hedging instrument need to be immediately reclassified to profit or loss.

In addition, any changes to the contractual terms of a financial instrument resulting from the COVID-19 outbreak may affect the instrument's eligibility as a hedged item. For example, a bank may be applying fair value hedge accounting to term deposits whose terms and conditions include significant penalties in the case of early withdrawals. If a bank waives its right to penalties to allow customers to withdraw deposits early, then the contracts could be viewed as demand deposits. This could mean that the hedging relationship is discontinued because there would be no fair value exposure to hedge.



Hedge effectiveness and ineffectiveness

The increased credit risk arising from the COVID-19 outbreak could affect both hedge effectiveness testing and the measurement of hedge ineffectiveness.

In addition, if there is an increase in the credit risk of a hedging instrument, then fair value changes due to the increased credit risk are not generally offset by changes in the value of the hedged item attributable to the hedged risk.

This may lead to increased ineffectiveness or even failure of the effectiveness requirements.



Disclosures

- When a company applies hedge accounting, it is required to disclose
- how it applies its risk management strategy and the effects on its financial performance and future cash flows. It is likely that the COVID-19 outbreak will affect these disclosures and a company will need to use judgement to determine the specific disclosures that are relevant and necessary for its business. Specific disclosures include:
 - changes in how the company manages risks;
 - impacts on hedge ineffectiveness;
 - forecast transactions that were subject to hedge accounting but are no longer expected to occur, and the related reclassifications to profit or loss; and
 - reclassifications of irrecoverable losses from the cash flow hedge reserve to profit or loss.



Actions for Management to take NOW

- Evaluate whether forecast transactions designated as hedged items in cash flow hedges continue to be highly probable. If a transaction is not highly probable, then consider whether it is still expected to occur.
- Determine whether any changes in the contractual terms of a hedged financial instrument resulting from the COVID-19 outbreak affect the instrument's eligibility to be a hedged item.
- Evaluate whether changes in the credit risk of hedging instruments and hedged items arising from the COVID-19 outbreak affect the assessment of hedge effectiveness and the measurement of hedge ineffectiveness.
- Evaluate whether accumulated losses in the cash flow hedge reserve will be recovered in future periods.

04. Have borrowers considered changes to the terms of their liabilities?

If borrowers have received concessions on their liabilities, then different accounting might apply.



Modification

When the contractual terms of a financial liability are substantially modified, it is accounted for as an extinguishment of the original debt instrument and the recognition of a new financial liability.

The new debt instrument is recorded at fair value and any difference from the carrying amount of the extinguished liability, including any non-cash consideration transferred, is recorded in profit or loss. Any costs or fees incurred are generally included in profit or loss, too.

If a modification to the terms of a financial liability (under the Government relief schemes), then the amortised cost of the liability is recalculated as the present value of the estimated future contractual cash flows, discounted at the adjusted effective interest rate which may be considered as applicable market rate..

The periodic re-estimation of cash flows to reflect movements in market rates of interest will change the effective interest rate of a floating-rate financial liability.

To determine whether a modification of terms is substantial, a borrower performs a quantitative assessment – i.e. a '10 percent test'. If the difference in the present values of the cash flows is less than 10 percent, then the borrower needs to perform a qualitative assessment to identify substantial differences in terms that by their nature are not captured by the quantitative assessment. Performing a qualitative assessment may require a high degree of judgement based on the facts and circumstances.



Extinguishing liabilities with equity instruments

Borrowers might use their own equity instruments to settle their debt instruments (e.g. debt-for-equity swaps) because of the liquidity impact from the COVID-19 outbreak. If equity instruments are issued to a creditor to extinguish all or part of a financial liability in a debt-for-equity swap, then the equity instruments are consideration paid.

The equity instruments are measured at fair value, unless that fair value cannot be measured reliably. In this case, the equity instruments are measured with reference to the fair value of the financial liability extinguished.

The difference between the carrying amount of the financial liability and the fair value of the equity instruments is recognised in profit or loss. If only part of the financial liability is extinguished by the issue of equity instruments, then a borrower needs to assess first whether a part of the consideration is for a modification of the liability still outstanding. If it is, then the consideration paid is allocated between the extinguished part and the part that remains outstanding.

The consideration allocated to the debt still outstanding forms part of the assessment of whether the modification is substantial. All relevant facts and circumstances need to be taken into account in making this allocation.



Actions for Management to take NOW

Management needs to consider:

- whether there are any changes to the terms and conditions of a financial liability and, if so, whether those changes are substantial;
- if equity instruments have been issued to settle all or part of a financial liability, whether the fair value of those equity instruments can be measured reliably; and
- if an equity instrument has been issued to settle part of a financial liability, whether part of the consideration is for the modification of the liability still outstanding.

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