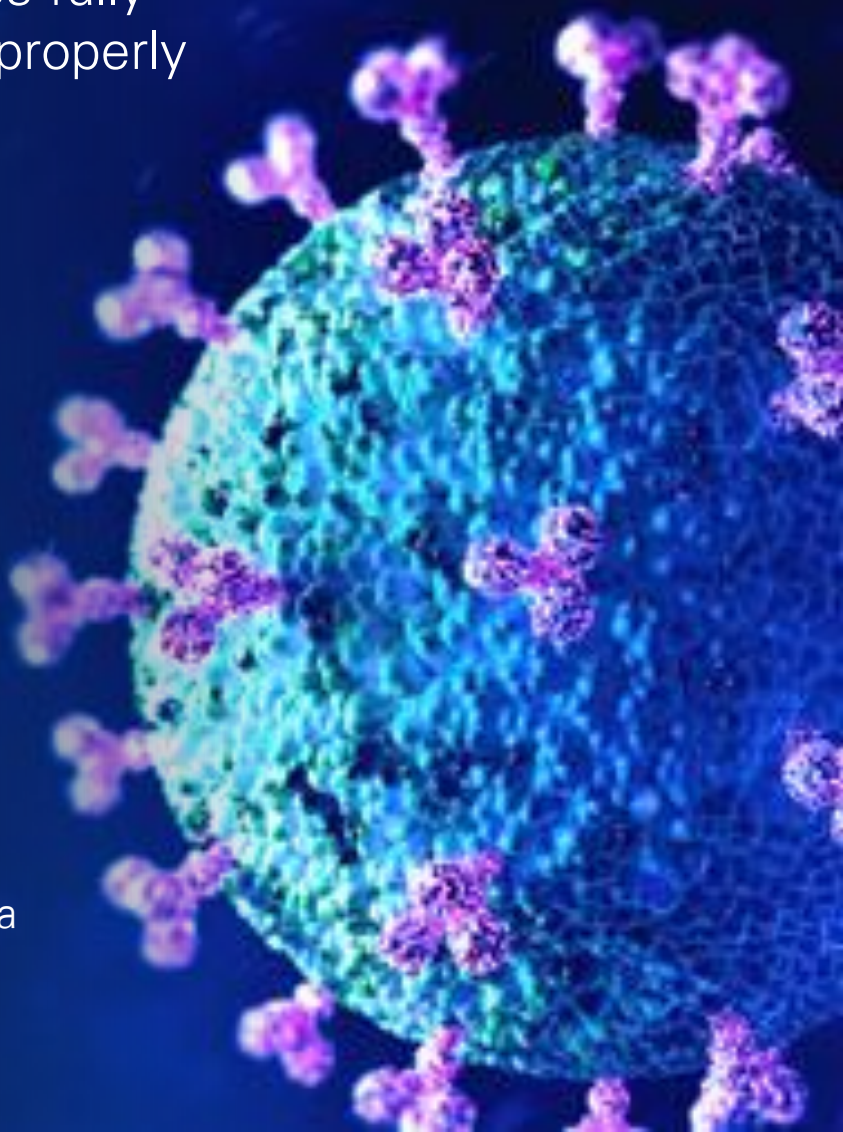
COVID-19 Financial Reporting Implications

Are all liabilities fully recorded and properly recorded?



Part 04

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.

KPMG Team has put together this summary which we believe will 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:

01. Has COVID-19 resulted in an unavoidable liability or a loss-making contract?

If COVID-19 results in a liability, or a contract becoming loss making, then the company needs to recognise a provision.

Onerous contracts

As the situation surrounding COVID-19 is rapidly changing, a company may need to update projections it made before the reporting date to reflect the information available, conditions and outlook at the reporting date.

The provision for an onerous contract is discounted if the effect of the time value of money is material. When Central Bank cuts interest rates in response to increasing concerns about the economic impact of COVID-19; it may in turn impact risk-free rates, which are often used to discount provisions. Companies need to update the discount rate if it has changed.

Before recognising a provision for an onerous contract, a company needs to test all assets dedicated to the contract for impairment.

Penalties

Companies need to review their existing contracts and consider the interpretation of applicable law, particularly force majeure clauses, to determine whether they have an obligation triggered by COVID-19. In some cases, this may require them to recognise additional provisions – e.g. for failure to comply with applicable laws and regulations.

Conversely, in some countries the outbreak may be regarded as force majeure and penalties for non-performance, late delivery or cancellation may be waived. This assessment may require legal advisors to be involved.

Future operating losses

A provision is recognised only for an existing present obligation – i.e. a company cannot recognise a provision for future operating losses or business recovery costs.

Actions for Management to take NOW

- Consider if COVID-19 has triggered a liability that would result in an outflow of resources.
- Review termination clauses in key purchase and sales contracts to determine whether the cost of exiting a contract is lower than the cost of fulfilling it. Consider if COVID-19 falls under the force majeure clause in the respective jurisdiction.
- Update projections of costs and benefits for the onerous contracts test. Ensure that the assumptions are consistent with projections made for other purposes – e.g. impairment analysis. Check whether the risk-free rate used to discount provisions has changed.
- Perform the impairment test first before recognising a provision for an onerous contract.
- Provide clear and meaningful disclosures about judgements and estimates made in recognising and measuring provisions.

02. When is the right time to recognise a restructuring provision?

If an entity plans restructuring to respond to COVID-19, then it recognises a restructuring provision only when specific conditions are met.

Recognition

If a company decides to close down one of its production facilities as a result of COVID-19, then the following needs to be considered;

- company announces its plan, specifying the facility to be closed,
- the estimated timing of the closure and
- the approximate number of employees it plans to make redundant then it recognises a restructuring provision.

The approval of the restructuring plan by the company's board is not by itself sufficient to recognise a restructuring provision.

Measurements

Restructuring provisions include only direct costs arising from the restructuring – e.g. employee termination benefits and consulting fees that relate directly to the restructuring, onerous contract provisions, contract termination costs and expected costs from when operations cease until final disposal.

Costs associated with ongoing activities are not included in restructuring provisions. For example, the costs of retaining or relocating employees, administration or marketing costs and investment in new systems are not recognised as part of a restructuring provision.

Actions for Management to take NOW

- Monitor government actions and consider all available government assistance when determining the need for restructuring.
- Assess whether the plan (or need for a plan) to restructure triggers impairment of assets and perform the impairment test if necessary.
- Ensure that a formal detailed restructuring plan is in place, and that those affected by the plan have a valid expectation that it will be carried out, before recognising a restructuring provision.
- Ensure that the restructuring provision does not include costs associated with the company's ongoing activities, unless they relate to an onerous contract.
- Provide clear and transparent disclosures about the nature of the restructuring provision, the expected timing of any resulting outflows of economic benefits and related uncertainties.

03. How does COVID-19 impact current and non-current classification of debt

The current conditions arising from the COVID-19 outbreak may trigger breaches of debt covenants or material adverse change clauses. Such breaches could cause debt to be classified as a current liability – i.e. if it becomes repayable on demand.

How debt covenants affect the classification of debt

When a company breaches a provision of a long-term loan arrangement on or before the reporting date such that the liability becomes repayable on demand, it classifies the liability as current. This is because the company does not have an unconditional right to defer its settlement for at least 12 months after that date.

However, if by the reporting date the company obtains from the lender an agreement to provide a grace period ending at least 12 months after the reporting date, then the liability is classified as non-current.
If the company obtains this agreement after the reporting date, then this is treated as a non-adjusting event. This means that the company is required to classify the liability, which is now repayable on demand as a result of the breach, as current at the reporting date.

Greater challenges in complying with debt covenants

In the current economic environment, it is likely that companies will find it more difficult to comply with debt covenants.

The following circumstances, either individually or collectively, could cause a significant deterioration of financial performance and financial ratios, which may in turn lead to a breach of debt covenants:

- a decrease in customer demand;
- a disruption in production or supply;
- an impairment loss caused by doubts about the recoverability of financial or non-financial assets that lead to impairment losses;
- a decrease in the market price of investments held; or
- an increase in the provision for certain obligations – e.g. those arising from onerous contracts or restructuring plans.

If a breach of covenant results in the debt becoming repayable before the contractual maturity date, then management would need to consider the breach as part of a broader assessment in determining the company's ability to continue as a going concern.

When a company breaches a debt covenant relating to borrowings recognised during and at the end of the reporting period, SLFRS 7 Financial Instruments: Disclosures requires specific disclosures in the financial statements.

Evaluation of subjective covenant clauses

Some loan agreements may include covenant clauses that are not based on financial ratios, making the determination of whether a breach occurs more subjective.

Some clauses could trigger an acceleration of repayment if, for example, the company's share price falls or the value of assets provided as collateral decreases.

Other clauses may be less definitive – e.g. a loan agreement may give the lender the right to demand immediate repayment when the borrower experiences 'significant financial difficulties'. However, this term may not be clearly defined in the loan agreement and companies will need to exercise judgement to determine whether a breach occurs on or before the reporting date.

Subsequent events

Any refinancing, amendments or waivers that are agreed after the reporting date are not considered in determining the classification of debt, but are disclosed as non-adjusting events.

Actions for Management to take NOW

- To assess whether debt subject to covenant clauses needs to be classified as current or non-current at the reporting date, management may need to do the following.
- Review covenant clauses in loan agreements and assess whether a breach has occurred or is likely to occur at the reporting date.
- Assess whether it is necessary to obtain a waiver or grace period from the lender if a breach has occurred.
- Evaluate the company's ability to maintain compliance with debt covenants and consider whether a renegotiation of covenant clauses with lenders is necessary.
- Provide the disclosures required under Accounting Standards.

Contact Us

Suren Rajakarier
Partner, Head of Audit
T: +94 11 542 6301
E : srajakarier@kpmg.com

Ranjani Joseph
Partner, Deputy Head of Audit,
Head of Markets
T: +94 11 542 6302
E: ranjanijoseph@kpmg.com

Raditha Alahakoon
Partner, Accounting Advisory
T: +94 11 542 6103
E: ralahakoon@kpmg.com

Follow us on,

KPMG Sri Lanka

@kpmgsl

www.home.kpmg/lk