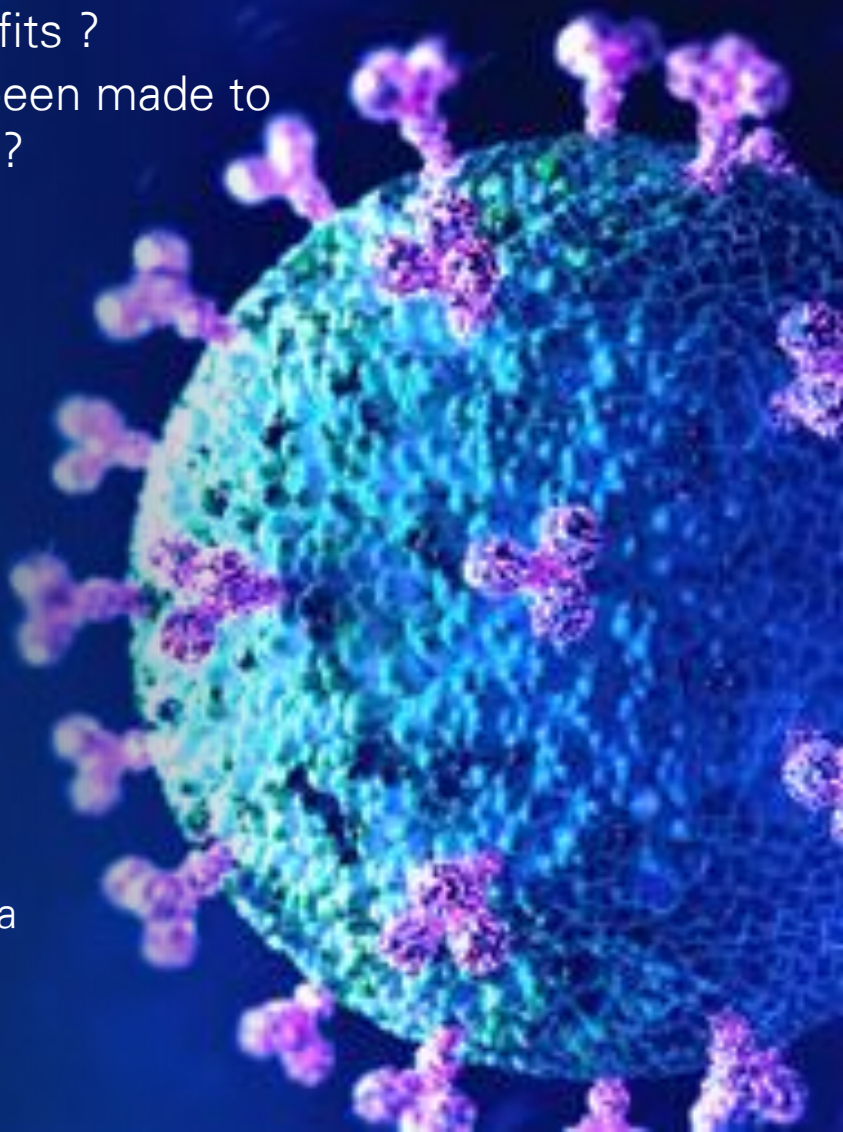
COVID-19 Financial Reporting Implications

What is the impact on employee benefits ?
Have changes been made to lease contracts ?



Part 05

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. What is the impact on Employee Benefits ?

Have there been changes to employee benefits and employer obligations?

Market volatility and changes to remuneration policies may impact how companies estimate and measure employee benefits and recognise share-based payment expenses.

Changes to remuneration policies

Some companies may offer their employees paid absence in addition to any sick or annual leave entitlement. If new paid absence entitlements do not accrue through past service and do not accumulate, then it is unlikely that a company would recognise a liability for these paid absences. Instead, it would expense the cost as absences are taken. Companies will need to consider, more generally, whether they have any legal or constructive obligations to its employees as a result of these events.

If a company implements a restructuring plan that includes employee redundancies, then it recognises an expense and a corresponding liability for termination benefits at the earlier of when it:

- recognises a restructuring provision under LKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* that includes the payment of termination benefits; and
- can no longer withdraw the offer of those benefits.

A company recognises a restructuring provision when it has a formal plan with sufficient detail of the restructuring and has raised a valid expectation in those affected by the plan – i.e. it has either started to implement the plan or has announced the main features to those affected by it.

Updating estimates, including actuarial assumptions

During periods of mandatory quarantine or lockdowns, employees could be required to use existing employee entitlements – e.g. sick or annual leave entitlements. Therefore, companies may need to consider the impact on the measurement of employee benefits – e.g. they may need to revise estimates of the likelihood and timing of employees using these entitlements.
There could also be an impact on certain demographic and financial assumptions used to measure these benefits – e.g. the discount rate used to measure the present value of employee benefit obligations.
Companies preparing interim financial statements should consider whether net defined benefit obligations/assets need to be remeasured.

Practically, many companies obtain actuarial valuations a few months before the reporting date. This is acceptable if the valuation is adjusted for material subsequent events up to the reporting date. Therefore, companies should consider the timing of their actuarial valuation reports and whether they reflect material events between the valuation and reporting date.

Share-based payments

Companies with share-based payments whose vesting depends on achieving non-market performance conditions – e.g. earnings per share targets – may need to revise their estimate of the number of instruments expected to vest, which would impact the charge in the income statement over the remaining vesting period. However, expectations of achieving market performance conditions – e.g. achieving a specified total shareholder return and non-vesting conditions – and grant-date fair value are not revised.

Modifications to share-based payment arrangements will need to be assessed as to whether they are either beneficial or non-beneficial to the employee and accounted for accordingly.
For example, if plans are modified such that market conditions are easier to achieve, then this may constitute a beneficial modification which increases the value of the award in the hands of the employee. In this case, the incremental fair value is recognised over the modified vesting period.

Actions for Management to take NOW

- Consider the appropriate accounting for new employee benefit arrangements – e.g. new remuneration policies.
- Assess when to recognise an expense and corresponding liability for termination benefits.
- Update estimates, including actuarial assumptions used to measure employee benefits, as appropriate.
- In preparing interim financial statements, consider the need for updated actuarial valuation reports and whether any plan remeasurements should be recognised.
- For any actuarial valuation reports obtained before the reporting date, consider how to reflect material events occurring between the valuation and reporting dates.
- Update the estimate of the number of awards that will vest for achieving non-market performance conditions in share-based payment arrangements.
- Evaluate whether modifications to share-based payment arrangements are non-beneficial or beneficial.

02. Have changes been made to Lease Contracts?

01. How should companies account for rent concessions?

Significant judgement may be required to determine how to account for rent concessions in real estate and other leases

Determining the nature of a rent concession

Many rent concessions will meet the definition of a lease modification – i.e. a change in scope or consideration that was not part of the original terms and conditions of the lease.

When this is the case, companies apply the detailed guidance in SLFRS 16 on accounting for lease modifications (see below).

In other cases, the original terms and conditions of the lease may include a mechanism to adjust rents if certain events occur. When this is the case, the rent concession will often represent a variable lease payment. Companies generally account for variable lease payments as income or expense in the period in which they arise.

Accounting for a rent concession that is a lease modification

To take a simple example, suppose a retailer leases a store from a landlord for a fixed term. The landlord classifies the lease as an operating lease. The retailer and landlord negotiate a change in the terms and conditions of the lease, so that the fixed rent is reduced by 50% for the next 12 months. There are no other changes to the lease.

The retailer and landlord account for this rent concession as follows.

- The retailer recalculates its lease liability, by discounting the new rent at a revised discount rate determined at the date the lease modification was agreed. The retailer adjusts the right-of-use asset by the amount of the resulting change in the lease liability.
- The landlord recalculates the straight-line operating lease income that it will recognise over the remaining term of the lease, based on the reduced rents. The landlord includes in this calculation any prepaid or accrued rents at the date the lease modification is agreed.

Other scenarios

In addition, lessors should consider whether:

- operating lease receivables are **impaired**;
- underlying assets measured at cost are **impaired**; and
- underlying assets measured at fair value – e.g. investment property measured at **fair value** – are appropriately measured.

Disclosures

Companies are required to disclose information about the effect that leases have on their financial position, financial performance and cash flows – including information about variable lease payments recognised as income/expense in the period.

Actions for Management to take NOW

- Review existing lease contracts to identify whether they contain rent adjustment clauses that may be triggered in the current conditions.
- Develop processes for real estate teams to report rent concessions to the finance function as they are negotiated and agreed.
- Identify and document key judgements made – e.g. in assessing the nature of the rent concession and, where relevant, determining the revised discount rate.
- Consider expanding disclosures on the accounting impact of rent concessions as a result of the outbreak.

02. Have changes been made to Lease Contracts?

02. Have expectations around lease renewal, termination or purchase options changed ?

Companies may need to remeasure lease assets and liabilities due to changes in economic incentives to exercise options in their lease contracts.

Reassessment of options

A lessee remeasures its lease liability when a significant event or a significant change in circumstances within its control changes any of its assessments about what is reasonably certain – i.e. to exercise a renewal or purchase option or not to exercise an option to terminate the lease early.

A lessee applies judgement when identifying significant events or significant changes in circumstances that trigger reassessment of these options. The lessee then considers the effect of current economic incentives to determine whether it is reasonably certain to exercise, or not to exercise, each option.

For example, a retailer concludes that revised commercial plans developed in response to the COVID-19 outbreak trigger a reassessment of renewal options in its store leases. In assessing whether it is reasonably certain to exercise the renewal options, the retailer considers the economic incentives existing at the date of the reassessment.

Accounting for reassessments

If a lessee changes its assessment of whether it is reasonably certain to exercise a renewal or purchase option, or not to exercise an option to terminate the lease early, then it remeasures its lease liability using a revised discount rate.
The lessee adjusts the carrying amount of the right-of-use asset for the remeasurement of the lease liability.

As a result, reassessment can have a significant impact on the carrying amount of lease assets and liabilities at the date of the reassessment. In turn, this may affect the amount and profile of depreciation and interest expense recognised subsequently.

For example, suppose a company that leases a vehicle initially assessed that it was reasonably certain to exercise an option to purchase the vehicle at the end of the lease term. As a result, it included the exercise price of the purchase option in the initial carrying amount of its right-of-use asset and lease liability, and depreciated the right-of-use asset over the useful life of the vehicle. Subsequently, the company concludes that it is not reasonably certain to exercise the purchase option.
It therefore remeasures the right-of-use asset and lease liability, and depreciates the right-of-use asset over the lease term.

What about lessors?

Lessees and lessors use the same guidance for assessing whether they are reasonably certain to exercise options on lease commencement. However, unlike lessees, lessors do not generally reassess their initial assessment of the lease term and purchase options.

Changes in the non-cancellable period of a lease

Decisions that companies make during this uncertain time may also affect how the non-cancellable period of a lease is determined. For example, the non-cancellable period of a lease will change if:

- the lessee exercises an option that was not previously included in the measurement of the lease liability;
- the lessee does not exercise an option that was previously included in the measurement of the lease liability;
- an event occurs that requires the lessee to exercise an option that was not previously included in the measurement of the lease liability; or
- an event occurs that contractually prohibits the lessee from exercising an option that was previously included in the measurement of the lease liability.

SLFRS 16 requires a lessee to revise the lease term and remeasure the lease liability using a revised discount rate when there is a change in the non-cancellable period of a lease.

Actions for Management to take NOW

- Consider whether COVID-19-related events and circumstances have triggered a requirement to reassess renewal, termination or purchase options.
- Consider the impact of any changes in economic incentives on whether a company is reasonably certain to exercise, or not to exercise, such options.
- Provide clear and meaningful disclosures about judgements and estimates made in reassessing lease options and lease terms.

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