

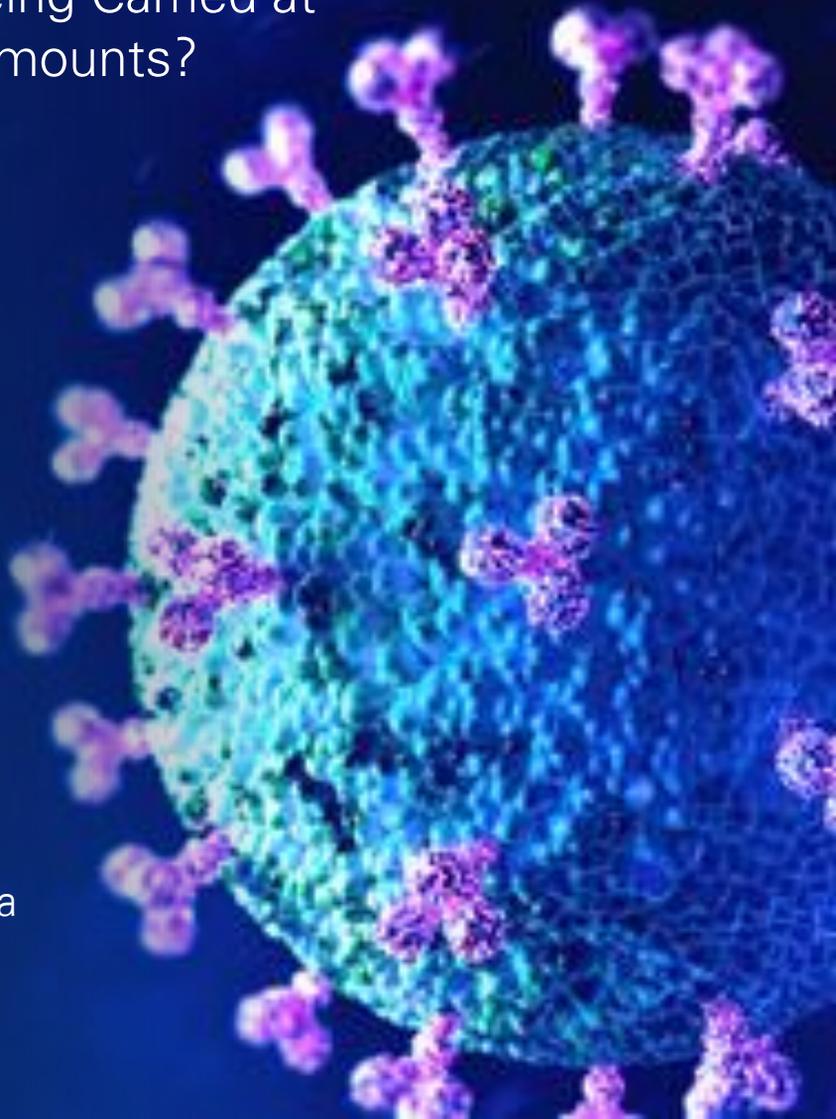


COVID-19 Financial Reporting Implications

Are Assets Being Carried at
Appropriate Amounts?

Part 01

KPMG in Sri Lanka



Content

The World Health Organisation has declared the COVID-19 coronavirus outbreak to be a pandemic. 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. Have non-financial assets become impaired?

Disruptions to business operations and increased economic uncertainty due to COVID-19 may trigger the need to perform impairment testing in the first quarter of 2020. Estimating future cash flows to calculate the recoverable amount will be challenging given the high level of uncertainty



Trigger for Impairment Testing

The impacts of COVID-19 have caused a significant deterioration in economic conditions for many companies, and an increase in economic uncertainty for others, which may constitute triggering events.

- Certain sectors have been significantly impacted – e.g. travel, tourism, entertainment, retail, construction, manufacturing, insurance and education.
- Companies in extractive industries may also have been significantly affected by decreases in commodity prices and companies in countries that are economically dependent on these commodities may also be exposed to a greater risk of adverse economic impacts.
- Certain types of investment properties (and right-of-use assets arising from leased real estate) – e.g. retail and industrial properties – may be considerably affected by COVID-19. Tenants that have been forced to suspend operations may not be able to pay rent in the near term or may ask to renegotiate a lower rent.
- Business operations hit by a fall in demand for their products or services, or by restrictions imposed by the state;
- Dependence on supply chains or have production facilities in countries significantly affected by COVID-19; and/or
- Trade with countries significantly affected by COVID-19.



Challenges in estimating Cashflows

Estimating future cash flows could be particularly challenging for many companies due to the increase in economic uncertainty. Due to the high degree of uncertainty and resulting challenges in forecasting cash flows, it could be helpful to base those forecasts on external sources such as economic projections by respected central banks and other international organisations. To cushion the economic and financial market impacts, government has committed to fiscal stimulus, liquidity provisions and financial support. Companies will need to understand the terms and status of these provisions and consider what impact they might have on their cash flow projections



Reflecting risks in the discount rate

COVID-19 might have a significant impact on the risk-free rate and on entity-specific risk premiums (e.g. financing risk, country risk and forecasting risk) used in determining the appropriate discount rate to discount future cash flows.



Considering the approach to projecting cash flows

Given the uncertain macroeconomic outlook, with scenarios ranging from economic disruption for a few months before economic activity returns to normal, through to a lengthy period of disruption triggering a significant recession, estimation uncertainty will be significantly higher than normal and there will probably be a wider range of reasonably possible cash flow projections.

Given the high degree of uncertainty, it may be helpful to consider using an expected cash flow approach as opposed to the traditional approach. Under the traditional approach, cash flows are not adjusted for risk but, rather, risk is reflected in determining the discount rate. Under the expected cash flow approach, the uncertainty about the future cash flows is reflected in the different probability-weighted cash flow projections used, rather than in the discount rate.

The expected cash flow approach inherently requires a more explicit consideration of the wider than normal range of possible future outcomes



Disclosure

Because the uncertainty associated with management's assumptions about the future is likely to be significant, it is important that management develops robust disclosures to help users understand the degree of estimation uncertainty that exists in estimating the recoverable amount and the sensitivity of the recoverable amount to reasonably possible changes to key assumptions. For example, it may be appropriate to disclose management's views about the degree of uncertainty associated with the macroeconomic outlook (such as the severity and duration of the impact that COVID-19 is expected to have on the company's business) and/or the potential significance of disruption to the supply chain, factory shutdowns, fall in demand etc.



Actions for Management to take NOW

Consider whether there are any indicators of impairment for the company's CGUs or assets that are tested on a stand-alone basis. In particular, assess:

- the impact of measures taken to contain COVID-19 on the company's business; and whether net assets exceed market capitalisation.
- Consider whether budgets and cash flow projections reflect the following to the extent applicable to the company, based on information available at the reporting date:
- projections of central banks and other international organisations about the duration and severity of the impact of COVID-19;
- supply of and demand for the CGU's products or services;
- the decline in economic activity;
- the impact of restrictions on transport, travel and quarantines;
- the impact of exchange rates and commodity prices; and
- the fiscal stimulus, liquidity provision and financial support from the state or international organisations.

Consider whether discount rates used in recent valuations have been updated to reflect the risk environment at the reporting date.

Consider enhancing sensitivity disclosures and disclosures about the key assumptions and major sources of estimation uncertainty in the interim and annual reports.

02. 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).



Disclosure

Given the impact of the increase in economic uncertainty on forecasting cash flows and other unobservable inputs used in valuation techniques (e.g. certain risk-adjusted discount rates), companies may need to provide 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.

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.



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.

03. Will taxable profits be available to recover deferred tax assets?

COVID-19 may impact projections of future taxable profits that are used to assess the recoverability of deferred tax assets.



Company's projections of future taxable profits

In the current circumstances, a company's projections of future taxable profits may be affected by:

- changes in forecast cash flows – e.g. expected decrease in production or sales prices vs increase in costs;
- changes in a company's tax strategies; and
- substantively enacted changes to the income tax law introduced as part of a government's measures in response to COVID-19 – e.g. tax reliefs for certain types of income, additional tax deductions, a reduced tax rate or an extended period to use tax losses carried forward

Some of these changes may reduce future taxable profits, while others may potentially increase them. In addition, some of the changes – e.g. government's measures in response to COVID-19 – may impact the timing of the reversal of temporary differences.

When preparing projections of future taxable profits for the purposes of the deferred tax asset recognition test, a company needs to reflect expectations at the reporting date and use assumptions that are consistent with those used for other recoverability assessments –.

If the recognition threshold is met, then the company recognises a deferred tax asset and measures it using the tax rate expected to apply when the underlying asset is recovered based on rates that are enacted or substantively enacted at the reporting date (similar to deferred tax liabilities and current tax).



Actions for Management to take NOW

- Monitor government actions and consider whether any income tax relief is available.
- Determine whether there is a substantively enacted change in the income tax law; if there is, then it may impact the recognition and measurement of deferred tax assets.
- Establish whether there is an intention to repatriate or distribute a subsidiary's profits, because this would trigger recognition of a deferred tax liability.
- Consider how the current economic conditions could affect the company's tax strategies and plans.
- Consider whether there is any uncertainty about income tax treatments.
- Update projections for the reversal of taxable temporary differences and for other future taxable profits, ensuring that the assumptions are consistent with those used for other recoverability assessments.
- Provide clear and transparent disclosure about judgements and estimates made in recognising and measuring deferred tax assets.

04. Are revenue-cycle assets recoverable?

Assets related to the revenue cycle – e.g. receivables, contract assets, inventories and capitalised contract costs – may need to be written down as a result of the COVID-19 outbreak.



Receivables and contract assets

Customers may struggle to pay amounts due under revenue contracts. Companies need to assess both receivables and contract assets for impairment under SLFRS 9 Financial Instruments – i.e. using an expected credit loss model. Companies present any impairment losses separately from revenue from contracts with customers, and disclose them separately from impairment losses from other contracts. Companies also need to consider carefully whether new and existing contracts meet the existence criteria in SLFRS 15 Revenue from Contracts with Customers. This may impact their assessment of whether to recognise revenue and related receivables or contract assets.



Inventories

The COVID-19 outbreak may affect the estimated net realisable value in several ways.

- Estimated selling prices may fluctuate due to changes in customer demand.
- Estimated costs to complete may change due to increases in the cost of materials or labour.

Companies need to estimate net realisable value based on the most reliable evidence at the time the estimate is made. Companies consider the effect of events occurring after the end of the reporting period to the extent that they confirm conditions existing at the reporting date.

These estimates may require significant judgement, particularly when inventories will not be realised for a long period of time.

Companies disclose the amount of any write-down of inventories recognised as an expense in the period.



Actions for Management to take NOW

- Assess both contract assets and receivables for impairment under SLFRS 9.
- Ensure that estimates of net realisable value for inventory reflect the latest expectations of selling prices and projected costs to complete.
- Consider whether the amortisation period for capitalised contract costs needs to be updated.
- Assess capitalised contract costs for impairment under the requirements in IFRS 15, considering changes in the expected amount of consideration and projected costs to provide goods or services.
- Provide clear and meaningful disclosures about judgements and estimates made in measuring revenue-related assets.

04. How might capitalisation of borrowing costs be affected?

Interruptions in construction and development projects due to the COVID-19 outbreak could lead to a suspension in the capitalisation of borrowing costs.



Suspension of projects

Government actions to fight the COVID-19 outbreak might cause many physical development projects to pause – e.g. because project workers need to stay at home. A company needs to consider both the expected length and the nature of the suspension when evaluating whether an interruption caused by the COVID-19 outbreak will continue for an extended period.

A company continues to capitalise borrowing costs if:

- the interruption is for only a short duration;
- it continues to perform substantial administrative or technical work; or
- it can demonstrate that the interruption is due to a common external event or is a typical part of the process.



Renegotiation of borrowings

Eligible borrowing costs for projects that have not been suspended for an extended period include interest expenses calculated using the effective interest method under SLFRS 9 Financial Instruments.

This includes the actual cost of borrowings taken out for specific qualifying assets and the weighted-average rate on general borrowings used to fund qualifying assets. Therefore, modifications to financial liabilities that are agreed with lenders may lead to adjustments to interest expense that affect the amount of eligible borrowing costs to be capitalised.



Actions for Management to take NOW

- Reassess whether long-term development projects on which borrowing costs are capitalised are being suspended for an extended period because of the COVID-19 outbreak.
- If borrowing costs continue to be capitalised, then consider whether the amounts to be capitalised should change as a result of modifications to the contractual terms of those borrowings

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