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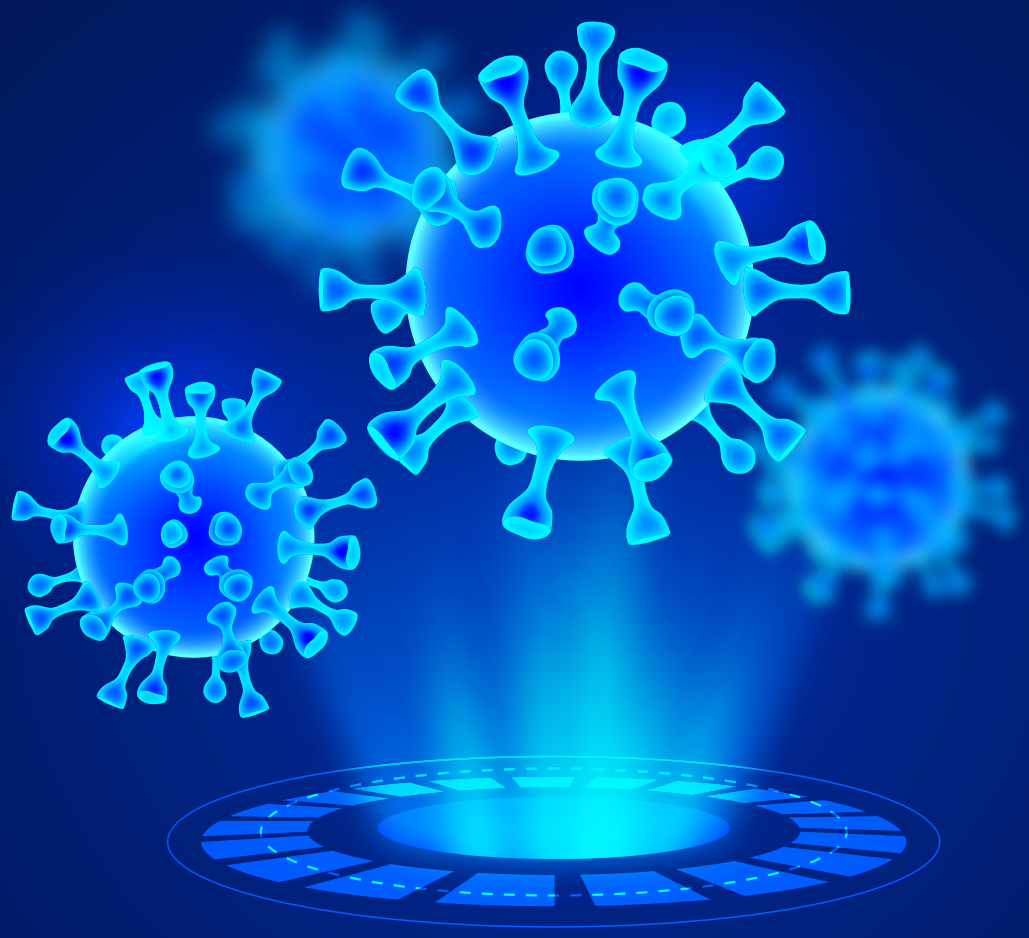

FREQUENTLY ASKED QUESTIONS (FAQs)

Guidance Notes on Accounting Considerations of the COVID 19 Outbreak (updated on 11th May 2020)

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on

Guidance Notes on

Accounting Considerations of the COVID 19 Outbreak

(updated on 11th May 2020)

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Inventory

Question 01

Considering the adverse impact of COVID-19 related events on businesses, what should be the key considerations of a company while estimating net realizable value (NRV) of the inventory?

Inventories shall be measured at the lower of cost and net realizable value (LKAS 2.9). The cost of inventories may not be recoverable if their selling prices have declined. The practice of writing inventories down below cost to net realisable value is consistent with the view that assets shall not be carried in excess of amounts expected to be realised from their sale or use (LKAS 2.28).

The consequences of COVID-19 might adversely affect the recoverability of inventories. The adverse consequences could include disruption in transportation arrangements and suppressed customer demand. The recoverability of inventory items from normal sale could be an issue, specially for companies holding perishable items or large quantities of inventories. Due to lockdown and uncertainty about the market conditions, company's inventory may require a write-down based on the NRV. However, another implication of disruption of business due to COVID-19 may affect in estimating NRV, such as:

- fluctuation in estimated selling prices due to changes in customer demand mainly for perishable goods or goods with short shelf lives.
- change in estimated costs to complete due to increase in the cost of material or labour.
- sales and purchase contracts may not be fulfilled resulting in excess inventory, in turn affecting NRV.

Entities would be required to use judgment in estimating the NRV of inventory under current circumstances. This shall reflect the latest expectations of selling prices and projected costs to complete after taking into account the impact of COVID-19. Further, the estimation of NRV shall also take into consideration fluctuations in selling price or costs to sell, based on the evaluation of subsequent events. In addition, interim inventory impairment losses shall be reflected in the interim period in which they occur, with subsequent recoveries recognised as gains in future periods.

Question 02

Due to closure/curtailment of operations, the production of inventory might decrease significantly. This could result in a prolonged shut-down or idle capacity of the production facility. How prolonged shutdown or idle capacity could impact the inventory costing?

The cost of inventories shall comprise of all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition (LKAS 2.10). The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. That would also include a systematic allocation of fixed and variable production overhead that are incurred in converting materials into finished goods (LKAS 2.12). The allocation of fixed production overhead to the costs of conversion is based on the normal capacity of the production facilities. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred (LKAS 2.12).

As a consequence of COVID-19 related restrictions, companies might have reduced the production levels. Significantly low production levels could be due to factors such as reduced demand, labour and material shortages, and unplanned facility or equipment downtime. Even if the company has significantly low production levels, some of the costs would still have to be incurred (i.e. fixed cost). The impact of allocation of fixed overheads to produced inventory would result in a significant increase in cost of produced inventory items. As a consequence of such low production or idle plant, the amount of fixed overhead allocated to each unit of production will not be increased instead unallocated overheads are recognized as an expense in the period in which they are incurred.

Property Plant and Equipment

Question 03

Companies might have completely closed or partially closed their operations and production facilities as a result of COVID 19 pandemic. In this scenario, shall a company cease to depreciate the plant/production facility and other assets?

Depreciation of an asset begins when it is available for use and depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale and the date that the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use, unless the asset is fully depreciated. However, under usage methods of depreciation, the depreciation charge can be zero while there is no production (LKAS 16.55).

Therefore, plants and production facilities that are temporarily shut down or idle due to current lockdown and market conditions shall continue to be depreciated. However, in case where

company applies a usage-based depreciation method, for example unit-of-production, then under such method no depreciation arises during a shut-down period since no units would be produced. Further, company also needs to consider that if an asset or component of an asset remains idle for a significant period of time, it may indicate potential impairment or demonstrate the need to reassess the asset's useful life. Further, this kind of a situation would indicate that the useful life of the asset needs to be reassessed.

Impairment of Assets

Question 04

What would be the considerations of a company for assessing recoverability of carrying values of property, plant, and equipment as a result of COVID-19 related events and conditions?

The scope of assets subject to the requirements in LKAS 36 is broad. It includes property, plant and equipment (carried at cost or revalued amount), intangible assets (carried at cost or revalued amount), goodwill and right-of-use assets (if carried at cost), investment property (if carried at cost), biological assets (if carried at cost) and investments in associates and joint ventures accounted for using the equity method.

Companies will need to assess whether the impact of COVID-19 has potentially led to an asset impairment. For most companies, the economic effects are likely to trigger an impairment test for long-lived assets and other asset groups. Estimates of future cash flows and earnings are likely to be significantly affected by either direct or indirect impact. Asset impairment may also reduce the amount of deferred tax liabilities and create additional deductibles. Ongoing identification and evaluation and re-evaluation are essential to understand the extent of the need for recognition and for what periods.COVID-19 related events including the lockdowns have adversely affected operations and finances of companies, leading to decreased demand for the products, supply chain disruptions and/or liquidity pressures.

An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset (LKAS 36.9). Accordingly, the recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs of disposal and its value in use. Then, Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date whereas, Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit (LKAS 36.6).

Accordingly, temporarily ceasing operations or suffering an immediate decline in demand or prices and profitability are the events that might indicate impairment. However, the impact of reduced economic activity and lower revenues are likely to affect almost any company and might also

indicate impairment. Therefore, those circumstances require an impairment test to be carried out to determine the recoverability of property, plant and equipment. Accordingly, impairment is recognised only if the recoverable value of the asset is less than carrying value of the asset.

Borrowing Costs

Question 05

Company might stop its operations and activities, owing to lockdown measures or liquidity crunch. How closure of operations and activities could impact the capitalisation of borrowing costs?

One of the key counter measures taken by the Government to limit the spread of COVID 19 pandemic involves complete or partial lockdowns at the city, district and or province level. This might have affected major construction activities on infrastructure development projects due to shortage or unavailability of labour and supplies.

An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as expenses in the period in which those are incurred. However, an entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset (LKAS 23.8 and LKAS 23.20).

The current economic turbulence resulting from the COVID 19 might warrant suspension of capitalization of borrowing costs as a result of the suspension of active development of on assets under development. Accordingly, it is required to expense the borrowing cost, during the suspension of the active development of qualifying assets even though the interest might have accrued using the Effective Interest Rate (EIR) and no capital payments have been made.

Accounting for Government Grants and Disclosure of Government Assistance

Question 06

How to recognise government grant through government assistance provided during COVID 19 Epidemic and record in the financial statements?

Government takes various relief measures and assistance to limit the adverse economic impacts of COVID-19 pandemic to the affected sectors of the economy. The accounting for government grants and assistance is covered under LKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance.*

Government assistance is actions by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. Government grants are considered to be the assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity (LKAS 20.3). Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the related costs for which the grants are intended to compensate are recognised as expenses (LKAS 20.12). Government assistance is subject to disclosure of the nature, extent and duration of the assistance in order ensure that the financial statements may not be misleading. (LKAS 20.36).

Accordingly, companies need to evaluate all the facts and circumstances of each type of government grant in the light of LKAS 20 guidance to determine the appropriate accounting treatment. Accordingly, whether the grant income shall be recognised as income immediately or shall be deferred are subject to the type of the grant, terms and conditions attached to it. For government assistance, a company is required to disclose nature and extent of such assistance.

Revenue

Question 07
Reassessment of Variable Consideration in Revenue as a result of COVID 19

The COVID 19 pandemic could affect revenue estimates in **ongoing customer** contracts in the scope of SLFRS 15, if contract with a customer includes variable consideration such as discounts, refunds, price concessions, performance bonuses and penalties.

When a contract with a customer includes variable consideration (e.g., discounts, refunds, price concessions, performance bonuses and penalties), an entity is generally required to estimate, at contract inception, the amount of consideration to which it will be entitled in exchange for transferring promised goods or services. The amount of variable consideration that an entity can include in the transaction price is constrained to the amount for which it is highly probable that a significant reversal of cumulative revenue recognised will not occur when the uncertainties related to the variability are resolved (SLFRS 15.50-51, SLFRS 15.56, SLFRS 87-88).

It is required to update the estimates throughout the term of the contract to depict conditions that exist as at each reporting date. This will involve updating the estimates of variable consideration (including any amounts that are constrained) to reflect an entity's revised expectations about the amount of consideration to which it expects to be entitled, considering uncertainties that are resolved or new information about uncertainties related to the coronavirus outbreak. Estimation of variable consideration and the constraint may require entities to exercise significant judgement and make additional disclosures. For example, an entity is required to disclose information about the methods, inputs and assumptions used for estimating variable consideration and assessing whether

an estimate of variable consideration is constrained. Entities need to also consider the requirements to disclose the judgements and changes in judgements that significantly affect the determination of the amount and timing of revenue.

Question 08

As a result of lockdown measures, a company might not be able to deliver goods to its customers. In such a case, how revenue recognition could be impacted?

The hurdles to deliver products to its customers could be due to various reasons, including travel and shipping restrictions or closure of customer's facility preventing physical delivery.

In terms of SLFRS 15, an entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when (or as) the customer obtains control of that asset. Accordingly, an entity shall determine at contract inception whether it satisfies the performance obligation **over time** or satisfies the performance obligation **at a point in time**. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. (LKAS 15.31 – LKAS 15.32)

An entity shall consider indicators of the transfer of control, which include, but are not limited to, the following as guided in SLFSR 15.38:

- Entity has a present right to payment for the asset;
- Customer has legal title to the asset;
- Entity has transferred physical possession of the asset;
- Customer has the significant risks and rewards of ownership of the asset;
- Customer has accepted the asset.

Accordingly, companies might need to make significant judgements considering all pertinent facts and circumstances to determine whether it has satisfied the performance obligations by transferring the promised goods to the customer. As an example, in cases where the performance obligation is satisfied upon delivery of promised goods to the customers, i.e. point in time, a company shall not recognise revenue where it has not been able to deliver the promised goods to the customer in accordance with the terms of contract.

However, the following criteria need to be met according to SLFRS 15.B81, in addition to applying the requirements in SLFRS 15.38 for contact which is for Bill and Hold arrangement.

(a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);
(b) the product must be identified separately as belonging to the customer;
(c) the product currently must be ready for physical transfer to the customer; and

(d) the entity cannot have the ability to use the product or to direct it to another customer.

Events after the balance sheet

Question 09

COVID-19 related events and conditions are expected to continuously develop and evolve. How company would evaluate whether COVID-19 related events are adjusting events or non-adjusting events?

It is to be noted that significant development and spread of the coronavirus did not take place in the country until January 2020 and as at 31 December 2019 only limited events and associated actions took place. There is a need to evaluate whether the consequences of COVID-19 represent subsequent events that need adjustments or disclosures in the financial statements at the reporting date.

Events after the reporting period include all events up to the date when the financial statements are authorised for issue, even if those events occur after the public announcement of profit or of other selected financial information (LKAS 10.7). An entity shall adjust the amounts recognised in its financial statements to **reflect adjusting events** after the reporting period (LKAS 10.8). An entity shall not adjust the amounts recognised in its financial statements to reflect **non-adjusting events** after the reporting period. (LKAS 10.10). In addition to this, if an entity receives information after the reporting period about conditions that existed at the end of the reporting period, it shall update disclosures that relate to those conditions, in the light of the new information (LKAS 10.19). If non-adjusting events after the reporting period are material, non-disclosure could influence the economic decisions that users make on the basis of the financial statements. Accordingly, an entity shall disclose the nature of the event; and an estimate of its financial effect, or a statement that such an estimate cannot be made.

For entities with annual reporting date as at 31 December 2019, COVID 19 is treated as a 'non-adjusting event'. Such judgement could be made based on the forecasts, projections and associated assumptions used in preparing financial statements for the year ended 31 December 2019 which could have impacted either little or no change as a result of the outbreak unless existence of a condition can be clearly demonstrated.

However, the effects and business implications caused due to the coronavirus condition is likely to be incorporated into the financial statements as an adjusting event supported by adequate disclosures for reporting periods ending thereafter (eg: for financial periods ending 31st March 2020).

Presentation and disclosures

Question 10

Due to COVID-19, a company may have recorded expenses or provisions of material amounts impacting current year's profitability. In view of the materiality and non-recurring nature of these expenses/provisions, can a company present these amounts, separately as extraordinary items in the statement of profit or loss?

An entity shall not present any items of income or expense as extraordinary items, in the statement(s) presenting profit or loss and other comprehensive income or in the notes (LKAS 1.87)

Present accounting standards do not define the term extraordinary items. However, previously this concept was contained in IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting*. That standard defined extraordinary items as income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly.

In substance, certain expenses/provisions as a consequence of COVID-19 may be non-recurring, distinct and significant. However, LKAS 1 prohibits the presentation of items of income and expense as 'extraordinary items' in the statement of profit or loss, statement of other comprehensive income and the notes. Therefore, in accordance with LKAS 1, no items of income and expense are to be presented as arising from outside the company's ordinary activities.

However, in terms of LKAS 1.29 an entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial. Therefore, LKAS 1.97 states that when items of income or expense are material, an entity shall disclose their nature and amount separately. As such, professional judgement need to be exercised in determining whether separate presentation is needed on the face of the financial statements or in the explanatory notes based on the materiality of the individual items.

In addition, LKAS 1.55 requires an entity to present additional line items (including by disaggregating the line items listed in LKAS 1.54), headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.

As a good practice on reporting, entities may also cover areas such as Alternative Performance Measures (APM) which may include:

- narrative information regarding the modifications made, the assumptions used and the impact of COVID-19;
- information on measures taken or expected to be taken by issuers to address the impact that the COVID-19 outbreak may have in their operations and performance.

Question 11

Companies may be required to make or update significant estimates based on the new and evolving information and circumstances. What could be the impact of these changes on the financial statement disclosures?

The current economic situation and its impacts on businesses has drastically increased the uncertainty about future market scenario. An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of their nature, and their carrying amount as at the end of the reporting period (LKAS 1.125).

Due to current market conditions, it may be necessary for the companies to make additional disclosures about significant accounting estimates and management judgments, especially those involving valuation and impairment. Estimates and judgments that are based on highly subjective assumptions (e.g., a valuation of financial instruments that is not based on observable market information, assumptions about future events and conditions) may be challenging.. Companies shall evaluate their disclosures to ensure that they accurately reflect the current uncertainty and meet the disclosure objective of LKAS 1.

Insurance Contracts

Question 12

How to measure the insurance liabilities arising from insurance contracts since COVID 19 considering the significant increase in risk?

The current coronavirus outbreak situation could affect an entity's liabilities for issued insurance contracts for a range of product lines. For example, entities issuing life or health products may be faced with claims caused by the impact of the outbreak on policyholders' health status. Entities may also be affected by claims where cover is provided for events driven by the disruption caused by the outbreak, for example, business interruption insurance, event cancellation insurance, travel insurance and credit insurance. However, since coronavirus is a new disease, contractual terms may not be clear on whether policyholders can claim against the insurer. As an example, entities also need to consider any interpretations, directives or rulings issued by local authorities that could impact the obligations under the contract for the entity.

An insurer shall assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities is inadequate in the

light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss (SLFRS 4.15).

Entities issuing insurance contracts will need to assess the impact of the coronavirus, or the disruption caused by it on their insurance liabilities based on their specific accounting policies. This includes the effect on the liability adequacy testing of the insurance liabilities. This assessment would need to consider factors including, but not limited to, the effect on reported claims, the effect on incurred but not (enough) reported claims, the impact of these effects on the assumptions for estimating expected future claims, and the impact on the entity's claims handling expenses. Where the entity reinsured risk from its insurance contracts, it needs to also consider the associated recovery through its asset from reinsurance contracts held. In determining these effects, the entity shall consider not only the terms and conditions of its insurance contracts, but also the implications of any interpretations, directives or rulings by local authorities for those terms and conditions. Where an entity's accounting policies for the measurement of its insurance liabilities may also involve the use of current estimates of market variables, for example, interest rates and equity prices, the entity shall reflect the impact of market developments on these variables in its measurement.

Provisions, Contingent Liabilities and Contingent Assets

Question 13

How a loss-making contract (i.e. an onerous contract) is identified and accounted for under LKAS 37?

As a result of COVID-19 related events, companies may have difficulties in meeting contractual obligations towards their counterparties, even though companies may have entered into renegotiations during the reporting period. However, at the reporting date companies may not be in a position to fully comply with the contractual terms. Further, the enforceable obligations under the contract might result in some existing purchase or sale contracts becoming loss making i.e. onerous.

This standard defines an onerous contract as a contract in which the **unavoidable costs of meeting the obligations under the contract exceed the economic benefits** expected to be received under it. Such unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision (LKAS 37.66 and LKAS 37.68).

Following factors are necessary to conclude whether the contract is onerous:

- assess the unavoidable costs of meeting the obligations under a contract at the reporting date considering standardised and non standardised contract terms.
- identify and quantify any compensation or penalties arising from failure to fulfill it.

- estimate the expected benefit under the contract (future cash flows) by exercising the management judgment considering past experience and expert advice.

Accordingly, it is required to provide provisions for onerous contracts, if that may relieve an entity from its obligations. However, it is not required to provide a provision over the contracts, if the contracts can be cancelled without paying compensation to the other party since there is no obligation. As an example, 'force majeure clauses' in the contracts would release the parties from effects of failure to perform if those are due to acts of God.

Question 14
How the Insurance Recoveries can be identified and accounted, if any?

Entities often enter into insurance policies to reduce or mitigate the risk of loss arising from business interruption or other events. The accounting for insurance claims will differ based on a variety of factors, including the nature of the claim, the amount of proceeds (or anticipated proceeds) and the timing of the loss and corresponding insurance recovery. Accordingly, an entity may experience a loss related to the coronavirus outbreak as a result of the shutdown of its production facilities as required by the government whereas, an entity continues to incur expenses for staff costs, rent and taxes etc.

An entity shall not recognise a contingent asset and that are not recognised in financial statements since this may result in the recognition of income that may never be realized. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and recognition is appropriate (LKAS 37. 31 and 37.33).

Accounting for insurance proceeds will be affected by the evaluation of coverage for that specific type of loss in a given situation, as well as upon an analysis of the ability of an insurer to satisfy a claim. Since, terms and conditions of an insurance policy are often complex, it may require evidence confirming that the insurer will be covering the claim. Accordingly, it is necessary to assess the availability of potential insurance recovery, availability of valid insurance policy for the incident and a claim will be settled by the insurer. Once it is established that it is virtually certain that the entity will be compensated for at least some of the consequences of the coronavirus outbreak under a valid insurance policy, any uncertainty as to the amount receivable should be reflected in the measurement of the claim.

Question 15

Can a company in anticipation of future operating losses record the same in the current reporting period?

As a result of current market situation due to COVID-19 pandemic, most of the companies might foresee future operating losses.

As stated in LKAS 37, provisions shall not be recognised for future operating losses since future operating losses do not meet the definition of a liability and the general recognition criteria set out for provisions in paragraph. However, an expectation of future operating losses is an indication that certain assets of the operation may be impaired (LKAS 37.63 - LKAS 37.65).

Accordingly, an expectation of future operating losses might be an indicator that certain assets in the operations may be impaired and such assets shall be tested for impairment in accordance with LKAS 36.

Question 16

A company might plan or start a restructuring plan due to COVID-19 related events and circumstances. What would be the key considerations for accounting and disclosure of the restructuring provisions?

Due to COVID-19, management may consider restructuring efforts such as closure of business location, change in the management structure or fundamental reorganisations that have a material effect on the nature and focus of the company's operations.

A provision for restructuring costs is recognised only when the general recognition criteria for provisions are met (LKAS 37.71). Accordingly, a constructive obligation to restructuring arises only when an entity has a **detailed formal plan** for the restructuring and has **raised a valid expectation** in those affected areas that it will carry out the restructuring by implementation of that plan or announcing its main features to those affected by it (LKAS 37.72).

Therefore, in current circumstances in order to recognise a restructuring provision, company shall ensure that the obligating event before the reporting date has created a provision. Once the nature of the restructuring costs has been identified, the provision is measured at the best estimate of the anticipated costs. That amount is discounted using a pre-tax rate that reflects both the time value of money and risks specific to the liability, if the financing component is material.

Employee Benefits

Question 17

How shall a company account for the recent decrease in the discount rate, while measuring its employee benefit liabilities under LKAS 19?

Recent reductions in the policy rates would have resulted in high liability of employee benefit obligation at the end of the reporting period due to the reduction in the interest rates that are used in measuring the present value of the liability.

The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined with reference to market yields at the end of the reporting period on high quality corporate bonds. For currencies where there is no deep market in such high-quality corporate bonds, the market yields (at the end of the reporting period) on government bonds denominated in that currency shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations (LKAS 19.83).

It is expected to use the risk free rates increased by the risk premium in arriving the corporate bond rates that could be used as the interest rates for this purpose unless deep market high quality bond rates are not available. It is recommended to use the applicable market rates as at the period end through orderly manner to measure the retirement benefit liability.

Financial Instruments

Question 18

In developing the ECL model, what shall be the key considerations of companies?

ECL measurements need to incorporate forward-looking information that is available without undue cost or effort at the reporting date (SLFRS 9.5.5.17). It may be particularly challenging to assess the economic impact of COVID-19 till the information is available on the outcome.

- **Re-segmentation of loan portfolios or groups or receivables:**
  For the purpose of measuring ECLs and for determining whether significant increase in credit risk (SICR) has occurred, an entity shall group financial instruments on the basis of shared credit risk characteristics and reasonable and supportable information available on a portfolio basis which may require considering re-segmenting of the portfolios.

  The occurrence of the might change the risk characteristics of certain loans or receivables, because the respective borrowers or customers might engage in business, or locate in areas,

which have been affected, or more vulnerable to be affected. As a result, there is a need to consider the re-segmentation of portfolios.

- **Exercise of the rebuttable presumption**
  In circumstances where reasonable and supportable information are not available in a structured manner; management may exercise its judgement taking into account their past experience, business model and the internal credit risk management framework in determining whether the presumption as per SLFRS 9 can be rebutted. Further, in taking such a determination considering the prevailing circumstances, the regulatory provisions also need be taken into consideration. However, it is to be noted that such rebuttal shall only be valid during similar conditions unless empirical data is available to rebut the presumption even thereafter.

- **Changes in the macro economic conditions**
  Changes in economic conditions shall be reflected in macroeconomic scenarios applied by the entities and in their weightings. 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.

- **Assess the impact from covenant breaches**
  A breach of the covenants of a credit contract is a possible indication of unlikeliness to pay under the definition of default. However, a covenant breach does not automatically trigger a default. Rather, it is important to assess covenant breaches on a case-by-case basis and determine whether they indicate unlikeliness to pay.

- **Consideration of government relief measures and long term forecasts**
  To mitigate the risk, it is critical that entities make well-balanced and consistent decisions that consider not just the potential impact of the virus, but also take full account of the unprecedented level of support provided by governments and central banks to protect the economy in the form of tax reliefs and moratoriums. Accordingly, due weight will need to be given to established long-term economic trends, given the challenges of preparing comprehensive forecasts far into the future.

Question 19
Would the COVID 19 outbreak be considered to result in increase in Significant Increase in Credit Risk (SICR)?

The COVID-19 impact on credit risk will be more severe and immediate in various sectors. SLFRS 9 requires the application of judgement and both requires and allows entities to adjust their

approach to determining ECLs in different circumstances. A number of assumptions and linkages underlying the way ECLs have been implemented to date may no longer hold in the current environment. Entities are not expected to continue to apply their existing ECL methodology mechanically.

As such, the extension of payment holidays granted to all borrowers in stressed/ specific industries under the government approved relief schemes shall not automatically result in all those instruments being considered to have suffered a 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 SICR would not occur over expected remaining lives of the receivables. In other words, the loans and advances are assumed to revert to normal loans upon the moratorium period.

Question 20
How would the impairment model be adjusted to reflect the effect of COVID 19?

It is required to incorporate reasonable and supportable information about past events, current conditions and the forecast of future economic conditions into the assessment of ECLs for financial assets not measured at fair value through profit or loss. Such an assessment shall be based on information at the reporting date and adjusted for subsequent available information. The increased credit risk faced by the lending institutions is related to exposures to borrowers in highly affected sectors. Provisions need to be estimated based on the ECL for the entire remaining life of a financial instrument, such as loans to borrowers whose credit risk has increased significantly since origination.

ECL is a probability weighted amount that is determined by evaluating a range of possible outcomes. Qualitative and quantitative disclosure enables users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. This includes the basis of inputs and use of assumptions and estimation techniques. It is required to calculate the explicit probabilities of default (PDs) for individual exposures and those would be used to perform quantitative assessments of SICR using reasonable and supportable information that is available without undue cost or effort at the reporting date. It is necessary to consider whether they can incorporate COVID-19-related changes in the risk of default into PDs for individual exposures on a timely basis. Further, available information would be used for cash flow assumptions in computation of individual significant loans. Please refer the practical expedients provided by CA Sri Lanka on the financial instruments (Section 01.04) in the Guidance Notes on Accounting Considerations of the COVID 19 Outbreak (updated on 11th May 2020)

Initially, it is likely to be difficult to incorporate the specific effects of covid-19 and government support measures on a reasonable and supportable basis. However, changes in economic

conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings. 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 shall continue to be monitored as new information becomes available.

Question 21

What practical expedients have been provided by CA Sri Lanka on the accounting for financial instruments?

CA Sri Lanka has decided to provide certain temporary practical expedients in the application of certain provisions in SLFRS 9, considering the insufficiency of updated information, uncertainty relating to borrowers repayment ability, resource constraints and various government relief measures as a result of the outbreak, even though circumstances require reassessment of all the factors for the preparation of financial statements for the reporting on 31 March 2020 financial statements and thereon subject to appropriate adjustments being incorporated, when the information become available subsequently. In addition, extensive disclosures need to be made in the 2020 reporting on the factors and assumptions used and changes made or not made to the ECL methodology.

Please refer Section 01.04 of the Guidance Notes on Accounting Considerations of the COVID 19 Outbreak (updated on 11th May 2020) for those practical expedients on the impairment provisioning as per ECL Methodology in terms of section 5.5 of SLFRS 9 and reclassification in terms of Section 4.4 of SLFRS 9.

Question 22

How do you account for the debt moratorium offered for the qualified advances and leases as a lending institution?

Central Bank of Sri Lanka has recently issued Circular Nos. 04 and 05 of 2020 on Concessions Granted to COVID - 19 Hit Businesses Including Self-Employment and Individuals. According to the recent operational instructions provided, following to be noted:

- Eligible customers are not required to pay installments to the bank from April 2020 till the end of the moratorium period.
- However, customer will be required to continue the monthly installments (as originally agreed with the customer) for additional time equal to the moratorium period.
- Lending institutions shall not charge any additional interest from customers for the moratorium period.

These may be changed as per the subsequent operational instructions being issued and or as agreed with the customers.

Please refer section 01.01 of the Guidance Notes on Accounting Considerations of the COVID 19 Outbreak (updated on 11th May 2020) the accounting treatment on both performing loans and non-performing loans along with the illustrative calculations.

Question 23

What is the applicable accounting treatment for the borrower who is eligible for the debt moratorium as discussed above?

The accounting treatment for the borrower who is entitled to the moratorium with interest and capital reliefs is the mirror of the accounting treatment of the lending institution as discussed in the question no: 22 since for the borrower such loan or advance is considered to be a financial liability. Those may have been accounted under the amortised cost.

However, in exercising the professional judgement in terms of SLFRS 9.3.3.2 and SLFRS 9.B3.3.6, to determine whether there is a substantial change in the terms as a result of the modification which results in derecognition of the financial liability; the discounted present value of the cash flows under the new terms need to be at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. Otherwise, it would be considered as a modification of that particular financial liability.

Question 24

If applicable, when would the modification gain or loss from the moratorium be recognized in the financial statements?

If there is a modification gain or loss arising from a modification of any loan or advance covered under the debt moratorium as discussed above that has to be accounted on the date of which the revised terms and conditions have been agreed by the lending institution with the borrower. In other words, the triggering point for both parties would be the date of acceptance of the application for the moratorium by the borrower after assessing the eligibility.

There is no guidance in SLFRS 9 on the line item in the statement of profit or loss and OCI in which gains or losses on the modification of financial assets should be presented. Accordingly, an entity exercises judgement to determine an appropriate presentation for the gain or loss. As an example, this could be presented netting off against the interest revenue in the books of the lending institution.

Question 25

What is the operational effective date of the moratorium discussed above?

In terms of the above stated two circulars issued by the Central Bank of Sri Lanka, the effective date of the moratorium would be from April 2020 onwards. This may require changes in the systems of the lending institutions from that period onwards as operational measure.

Question 26

How should a company account for the interest free loans or below the market rate loans?

SLFRS 9 requires all financial instruments to be measured on initial recognition at fair value. If the loan is not on normal commercial terms (eg: carries below market rate of interest), the below market element of the transaction needs to be evaluated and separately accounted for. Accordingly, the difference between the gross carrying amount of loan proceeds and the fair value shall be reported as interest income in the statement of profit or loss. The subsequent unwinding of discount shall be reported as interest expense in the statement of profit or loss.

However, working capital loans and overdrafts offered at concessionary rates in terms of the Circular Nos. 04 and 05 of 2020 on Concessions Granted to COVID - 19 Hit Businesses Including Self-Employment and Individuals issued by Central Bank of Sri Lanka, (where the government has also been funded the lender to offer the facility) could be considered as special type products. In that case, the interest rate offered by the lending institutions for that special product would be considered as applicable market rate resulting in no fair value adjustments being needed and as such no day 1 impact would arise. Under the government refinance scheme recently announced with the COVID 19 outbreak, the lending institutions are funded at 1% where they could offer such loans at 4% to the eligible borrowers.

Fair Value Measurement

Question 27

How would the fair value measurement of assets and liabilities be affected due to COVID 19 outbreak?

A change in the fair value measurement affects the disclosures required by SLFRS 13, which requires companies to disclose the valuation techniques and the inputs used in the FVM as well as the sensitivity of the valuation to changes in assumptions. Disclosures are needed to enable users to understand whether COVID-19 has been considered for the purpose of FVM. A key question is what conditions and the corresponding assumptions were known or knowable to market participants at the reporting date.

For 2020, fair value measurements, particularly of financial instruments and investment property, will need to be reviewed to ensure the values reflect the conditions at the balance sheet date. This will involve measurement based on unobservable inputs that reflect how market participants would consider the effect of COVID-19 in their expectations of future cash flows related to the asset or liability at the reporting date.

During the current environment, the volatility of prices on various markets has also increased. This affects the fair value measurement either directly - if fair value is determined based on market prices (for example, in case of shares or debt securities traded on an active market), or indirectly - for example, if a valuation technique is based on inputs that are derived from volatile markets. Consequently, special attention will be needed on the commodity price forecasting that is used in developing fair value conclusions.

When there is a significant decrease in volume or level of activity or if the transaction has not been taken place in an orderly manner an entity may consider way forward with an alternative valuation technique or incorporate certain adjustments to the existing valuation technique in deriving the fair value of an asset or liability.

Question 28

What practical expedients have been given by CA Sri Lanka for the valuation of financial assets?

Section 02 of the Guidance Notes on Accounting Considerations of the COVID 19 Outbreak (updated on 11th May 2020) provides a practical expedient in measuring the fair value of the financial assets. Accordingly, if an entity determines that 31st December 2019 prices would more appropriately reflect the fair values for 31st March 2020 reporting those values would be continued to use for the fair valuation of financial assets. Further, if an alternative valuation is used, such values shall not exceed the values reported as at 31st December 2019 in case of the financial assets.

Question 29

Will the above temporary practical expedient be applied to the financial assets acquired subsequent to 31 December 2019?

Alternative method of valuations could be applied in the 31st March 2020 reporting to acquisitions made subsequent to 31 December 2019 provided that the fair value arrived so do not exceed the volume weighted prices as at 31 December 2019.

Interim Reporting

Question 30

How does the impact of COVID 19 affect annual financial reporting as well as interim reporting as per LKAS 34?

The impact of COVID 19 would extend for the reporting during 2020 including the interim reporting and beyond. Some companies may first report financial effects of the outbreak in interim financial statements in accordance with LKAS 34 Interim Financial Reporting, which will likely involve the greater use of accounting estimates. However, information must be reliable and all material financial information relevant to an understanding of the financial position or performance of the company shall be appropriately disclosed.

Deferred Tax

Question 31

COVID-19 might adversely impact future profitability of companies. How these adverse conditions may impact recognition and realisability of deferred tax assets?

Under LKAS 12, *Income Taxes,* companies recognise deferred tax, mainly reflecting the origination and reversal of temporary differences and the benefits arising from unused tax loses, tax credits or temporary differences.

The recognition of deferred tax asset for unused tax losses and unused tax credits is based on the general principle that:

- It is probable that company will have future taxable profits; and
- Against those future taxable profits the unused tax losses and unused tax credits can be utilized.

LKAS 12 also requires companies to reassess the realisability of the deferred tax assets at each balance sheet date. Accordingly, companies are to make judgement based on the available information, for not only recognising deferred tax assets, but also for their realisability in coming periods.

LKAS 12 also note that the existence of unused tax losses is a strong evidence that future taxable profit may not available. As a result, the deferred tax asset recognition principle applies. While companies might have history of recent losses, the recognition of a deferred tax assets arising from unused tax losses or unused tax credits is only to the extent that the company has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the company.

While assessing the realisability of deferred tax assets, the company is also required to consider the events occurring subsequent to a company's balance sheet date, but before the financial statements are issued (that provide additional evidence regarding the likelihood of realisation of existing deferred tax assets).

As a consequence of current market situation due to COVID-19 pandemic, companies are expected to face decline in sales and lower profitability. Further, as noted, the existence of unused tax losses is a strong evidence that future taxable profit may not be available. The expected losses in early future years (post COVID-19 year-ends) and uncertainties whose unfavourable resolution would adversely affect future results are also negative evidence to be considered.

Therefore, companies would have to re-assess their assessment of the realisability of its deferred tax assets recognised in the latest financial statements. Accordingly, in the cases where companies do not foresee availability or future profits due to effects of COVID-19 related events, it would have to derecognise the deferred tax assets above the threshold of available taxable temporary differences.

Question 32

When an announced tax rate(s) could be considered as substantively enacted for the purpose of LKAS 12 Income Taxes?

Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. (LKAS 12.46 and 12.47).

Guideline on Application of Tax Rates in Measurement of Deferred Tax issued by CA Sri Lanka in 2015 states that the substantively enacted rate that shall be used in the measurement of deferred tax shall be the rate legislated as of the reporting date.

The International Accounting Standards Board (IASB) has decided as part of the US / IFRS convergence project on the replacement of IAS 12 to clarify that ‘substantively enacted’ means that any expected change in the tax rate has been virtually certain. Having noted that in some jurisdictions, enactment might not be virtually certain until the changes is signed into law, the Board decided that reaching a specified stage in the process shall be required. It further decided that the specified stage shall be the process of enactment is complete, which is when the remaining steps will not change the outcome.

Accordingly, a country's enactment process has to be sufficiently progressed to a stage in order for an announced tax rate to be considered as 'substantively enacted'. Accordingly, an income tax rate(s) to be considered as substantively enacted for the purpose of LKAS 12, the legislative process relating to such amendment need to be completed. Until such time, prevailing legislated rates have to be considered for the purpose of LKAS 12 in determining as substantively enacted.

In addition, LKAS 12.88 as well as LKAS 10.22(h) state that where changes in tax rates or tax laws are enacted or announced after the reporting period, an entity discloses any significant effect of those changes on its current and deferred tax assets and liabilities.