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

Background:

The COVID 19 outbreak poses a serious public health threat. It has interrupted the movement of people and goods throughout the world, and many jurisdictions have imposed restrictions on individuals and businesses. The resulting impact on financial reporting may be significant for many of the business organisations and industries.

Financial reporting considerations of the outbreak may be similarly broad for entities, and the precise effects will depend on the facts and circumstances of each entity. As time elapses and the effects of the outbreak change and evolve, it may become difficult to distinguish which information and facts and circumstances need to be incorporated into the measurements as at the end of the reporting period and which shall result in potential subsequent event disclosures supported by several changes in estimates, assumptions and other analyses in a more descriptive manner. This updated pronouncement therefore intends to provide guidance on the financial reporting considerations of the following areas in the backdrop of COVID 19:

01. Financial Instruments
02. Fair value measurement of Financial Assets
03. Impairment of Assets
04. Going Concern
05. Events After the Reporting Period
06. Recognition of Deferred Taxes
07. Lease Modifications

01. Financial Instruments

01.01 Accounting for Debt Moratoriums and Working Capital Loans at Concessionary Rates as per Circulars No: 4 and 5 of 2020 issued by Monetary Board, Central Bank of Sri Lanka

The extension of payment holidays granted to 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 Significant Increase in Credit Risk (SICR). Consideration also need to be given on whether the concessions under moratoriums could enable certain borrowers to resume regular payments in the foreseeable future (whom otherwise would have fallen into financial difficulty), such that significant increase in credit risk would not occur over expected remaining lives of the receivables. Identifying SICR is usually material for banks and other financial institutions. As such, explicit probabilities of default (PDs) would be calculated 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. Paragraphs 5.5.9 – 5.5.11 and B5.5.12 provide additional guidance for this purpose. 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.

01.01.01 Performing Loans under the moratorium

It is required to ascertain the entire remaining loan period including the moratorium and the extended tenure and revise the cash flows accordingly. In such a modification, interest has to be accrued throughout that period (during the moratorium and extended tenure) applying the original Effective Interest Rate (EIR) in accordance with SLFRS 9.5.4.1 and SLFRS 9.5.4.2 applied to the gross carrying amount of the financial assets. Accordingly, the modification gain or loss shall be charged to profit or loss immediately (SLFRS 9.5.4.3 and SLFRS 9.B5.5.27). This is on the basis that the modification is not substantial upon exercising judgement by the management.

However, applying the analogy of SLFRS 9.3.3.2 and SLFRS 9.B3.3.6, professional judgement has to be exercised in determining whether there is a substantial change in the terms as a result of the modification. If the management concludes that there is a substantial modification, that would result in derecognition of the financial asset. Consequently a new financial asset would be recognised and the EIR would be restated based on the pre modification carrying value and the revised cash flows. Please refer the annexure for illustrative calculation which has been structured on the basis that additional interest would not be charged on the outstanding during the moratorium period and if there is a change in that structure where additional interest is charged, that has to be brought into the calculation.

01.01.02 Non - Performing Loans under the moratorium

As per SLFRS 9, interest revenue shall be accrued in the financial statements for the credit impaired assets, by applying the original EIR on the net carrying value, after adjusting for Expected Credit Loss (ECL).

Paragraph B5.5.33 further states that for a financial asset that is credit-impaired at the reporting date (not a purchased or originated credit-impaired financial asset), an entity shall measure the ECL as the difference between the asset's gross carrying amount and the present value of estimated future cash flows discounted at the financial asset's original EIR. On restructuring consequent to the moratorium, the revised estimated future cash flows would be discounted applying the original EIR, and any adjustment to the already recognized ECL would be immediately recognised in the profit or loss.

The above treatment is applicable where the management judgement is that there is no substantial modification arising from the moratorium. Similar to the performing loans, if there is a substantial modification, original financial asset is dereognised and a new financial asset is recognised.

01.01.03 Working Capital Loans and Overdrafts at Concessionary Rates

Considering the special nature of the product concerned which is offered at a concessionary rate of 4% to the borrower, which is again funded to the lender at 1% interest rate under the government refinance scheme; the interest rate of 4% for this special product will be considered as applicable market rate resulting in no fair value adjustments. Accordingly, no day 1 impact would arise in case of such working capital loans and overdrafts.

01.02 Segmentation of Portfolios and ECL Assessment

Due to the disruptions in the business operations, some business entities might have impact on the credit quality across the value chain which lead to issues in the liquidity and credit quality. That may require need to segment the portfolios and revise ECL assessment as appropriate.

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). This may be particularly challenging to do for the economic impact of COVID 19. 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. However, in circumstances where reasonable and supportable information are not available in a structured manner; the 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, the regulatory provisions also need be taken into consideration.

Changes in economic conditions shall 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 should continue to be monitored as new information becomes available. In addition, 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.

Any changes made to ECL to estimate the overall impact of COVID 19 will be subject to very high levels of uncertainty as so little reasonable and supportable forward-looking information is currently available on which to base those changes. This makes it even more important that ECL is implemented well and on the basis of the most robust reasonable and supportable assumptions possible in the current environment. 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 detailed forecasts far into the future.

01. 03 Additional Disclosure Requirements

With the objective of evaluating the nature and extent of risks arising from financial instruments to which the entity is exposed and how to manage those risks; SLFRS 7 *Financial Instruments: Disclosures* requires the entities to disclose quantitative and qualitative information about the nature and extent of risks arising from financial instruments, which would sufficiently enable users of financial statements to evaluate the nature and extent of the exposed risks arising from financial instruments.

The disclosures on the risks on financial instruments would include credit risk, liquidity risk and market risk, and how such risks have been managed (SLFRS 7.32). Further, the qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and hence form an overall picture of the nature and extent of risks arising from financial instruments to evaluate the exposure to such risks (SLFRS 7.32A). In addition, it is required to disclose the concentrations of risks that the entity has been exposed to (SLFRS 7.34(c)).

An entity is required to disclose the nature and extent of risks arising from financial instruments and how it manages those risks. Therefore, the entity would need to explain the significant impact (including the potential impact) of COVID 19 on the risks arising from financial instruments and how it intends to manage those risks. It will need to use judgement to determine the specific disclosures that are relevant to its business and necessary to meet these objectives. Accordingly, an entity needs to provide extensive disclosures in relation to the expansion of the exposures to credit risks as a result of significant judgments and estimates on the possibilities of defaults and breaches of contracts; liquidity risks due to liquidity issues that affect continuity of operations; and market risks due to factors such as exchange rates, interest rates and other price risks supported by sensitivity analyses.

Examples of specific disclosures include the following:

- Information about an entity's credit risk management practices and how they relate to the recognition and measurement of ECLs. A company may have changed its risk management practices in response to COVID 19 – e.g. by extending debt relief to borrowers or by following specific guidance issued by governments or regulators;
- The methods, assumptions and information used to measure ECLs. For example, an entity may need to explain how it has incorporated updated forward-looking information into measuring ECLs, in particular:
    - how it has dealt with the challenge of ECL models that were not designed for the current economic shocks; and
    - how it has calculated overlays and adjustments to these models.

- Quantitative and qualitative information that allows evaluation of the amounts arising from ECLs, types of analysis disclosed previously may need to be adjusted or supplemented to clearly convey impacts arising from COVID 19;
- Information on the assumptions that the entity has made about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in material adjustment within the next financial year (LKAS 1.125).
- Policies and procedures for valuing collaterals;
- Update identified concentrations in the areas that are affected by the outbreak.

In addition to the general disclosures required, with regard to impairment requirements of financial assets which have had modifications to their contractual cash flows need to provide disclosures required by SLFRS 7.35F(f), SLFRS 7.35I(b) and SLFRS 7.35J.

01.04 Temporary Practical Expedients

ECL measurements need to incorporate forward-looking reasonable and supportable information available without undue cost or effort at the reporting date (SLFRS 9.5.5.17). Accordingly, 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. To assess SICR, SLFRS 9 requires that entities assess changes in the risk of a default occurring over the expected life of a financial instrument. Entities are required to develop estimates based on the best available information about past events, current conditions and forecasts of economic conditions. In assessing forecast conditions, consideration need to be given both to the effects of COVID 19 and the significant government support measures being undertaken.

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. Accordingly, an entity may continue using the information used for Probability of Default (PD), Loss Given Default (LGD), Economic Factor Adjustment (EFA) and cash flow assumptions in 31 December 2019 during the January to March period 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.

#	Element	Practical Expedient
I. Impairment Provisioning as per ECL Methodology in terms of Section 5.5 of SLFRS 9		
1.	PDs and LGDs and EFA and resulting modeling	PDs and LGDs and EFA used in 31 December 2019 (audited figures) may be used for the reporting on 31 March 2020 (or latest till 30 September 2020) after exercising professional judgement on the sufficiency of the availability of the required information to make any adjustments. On EFA, it is expected that weightage assigned to worst case scenario has to be increased by transferring the weightage from base case/ best case scenario to worst case scenario in the 31 March 2020 reporting or at the latest from the reporting cycle for 30 June 2020 onwards.
2.	Cash flow assumptions used in Dec 2019 for recovery period for computation of individual significant loans	Cash flow assumptions used in Dec 2019 for recovery period may be used for computation of individual significant loans in the 31 March 2020 reporting, if adequate information is not available to assess the cash flow forecasts. However, Industry wide benchmarking on the recovery period on the affected sectors need to be developed and followed by the lending banks and financial institutions for this purpose adjusting the cash flow assumptions for computation of ECL for individually significant loans from at least for the reporting cycle for 30 June 2020 onwards.
3.	Staging of the loans (including the elevated industries)	An entity may continue the same staging that exists as at 31 December 2019 till 30 September 2020, which is end of the debt moratorium period. It is expected that the lending institutions would do the risk assessment and the resulting adjustments; monitor customer payment patterns and reflect in the staging and assess the staggering of the cash flows due to moratorium. Further, weightage assigned to worst case scenario need to be increased from 30 June 2020 reporting onwards. The above approach shall not be used to upgrade facilities unless improvement in credit risk is clearly established. This means the restructuring and rescheduling based on debt moratorium cannot be used to upgrade facilities.
4.	Objective evidence triggers due to COVID 19	An entity may not consider the objective evidence triggers due to COVID 19 in the assessment of impairment provisions till 30 September 2020. However, such objective evidence triggers need to be considered when the information become available.

#	Element	Practical Expedient
5.	Exclude write offs, arising from COVID 19, in computing LGDs	COVID 19 related implications on impairment may not be incorporated into the ECL models until end of September 2020 if information is not available. Accordingly, write off due to COVID 19 need not result in adjustments to LGDs used by the lending institutions, However, in December 2020 reporting, the resulting impact needs to be reflected in the LGD computations.
6.	Impairment provisioning on Sri Lanka Development Bonds (SLDB)	In the event, there is lack of access to reasonable and supportable information including the rating, an entity may use the same PD used as at 31 December 2019 and the LGD as well for the impairment computation during the 31 March reporting. However, required adjustments will have to be made to PDs from 30 June reporting onwards.
II. Reclassification in terms of Section 4.4 of SLFRS 9		
7.	Reclassification of debt and equity portfolios	In terms of SLFRS 9.4.1.4, presenting subsequent changes in fair value in other comprehensive income for equity instruments that would otherwise be measured at fair value through profit or loss is an irrevocable election at initial recognition. However, as a result of COVID 19 if an entity decides to change its business model as at 1 January 2020, a one off option (no further reclassification thereon) is provided to reclassify equity portfolio. Accordingly, if the equity portfolio is reclassified to FVTOCI, the gain or loss on disposal will also be recognised in OCI. There will not be an option given for subsequent reclassifications. Similar reclassification may be made for the debt portfolios as well based on the change in business model following SLFRS 9.4.4.1.

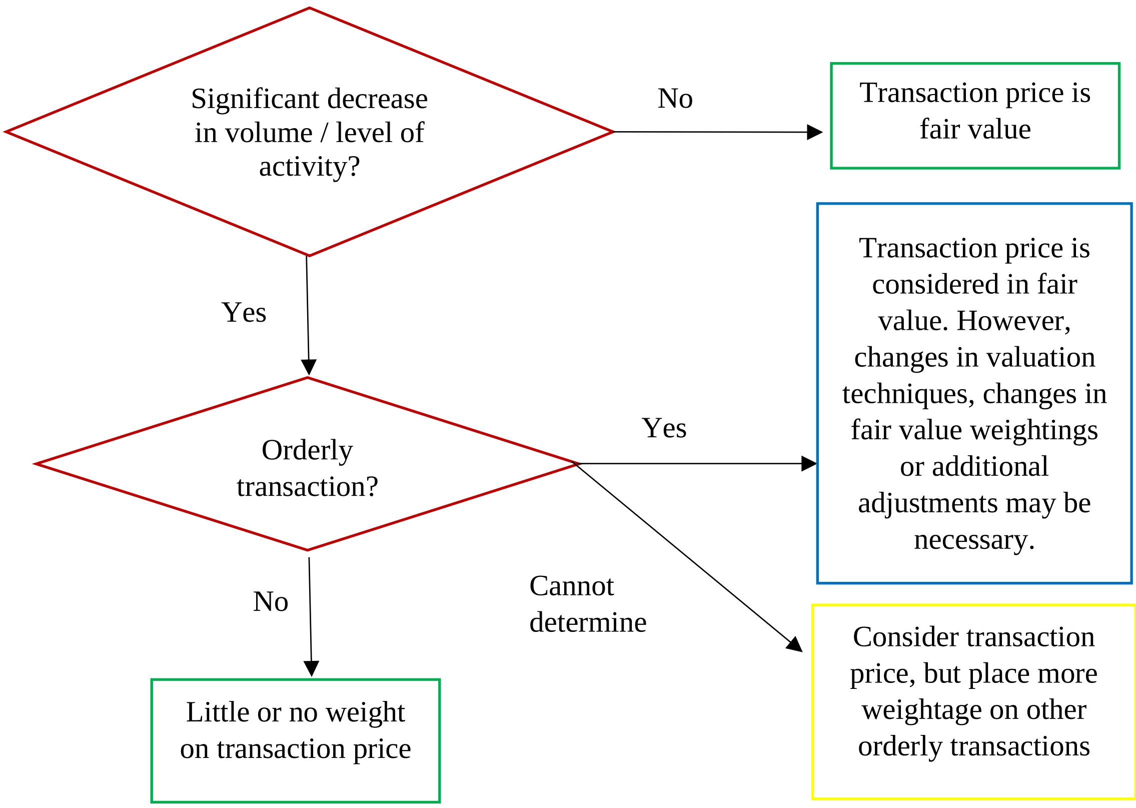
02. Fair value measurement of Financial Assets

In terms of SLFRS 13, when measuring fair value, an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. However, fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities) in terms of SLFRS 13.B37 as further guided in SLFRS 13.B38. Accordingly, such further analysis concludes following circumstances:

(a) The transaction or quoted price still represents fair value. i.e. decline in volume/activity, on its own, may not indicate that the quoted price does not represent fair value;
(b) The transaction or quoted price does not represent fair value. In such cases, an adjustment is required if;
  - those prices are still used as the basis for measuring fair value and the adjustment may be significant to the fair value measurement;
  - other circumstances necessitate the adjustment – for example, when a price for a similar asset requires significant adjustment to make it comparable to the asset being measured or when the price is stale;
(c) The transaction is not orderly.

Where the decrease in volume/activity necessitates an adjustment, SLFRS 13 prescribes the requirements in terms SLFRS 13.B39 and SLFRS 13.B40. According to the above provision, a change in valuation technique or the use of multiple valuation techniques may be appropriate in such situations. When multiple techniques result in a wide range of fair values resulting further analysis may be required.

Considerations in determining the level of reliance on market prices, assuming that the transaction price was fair value before the decline in activity are as follows:



As a result of the impossibility to fair value due to unavailability of reliable information or distress prices, an active market may not exist for respective equity instrument to measure the fair value of financial instruments at level I. The COVID 19 pandemic has significantly affected financial markets in the first quarter of 2020. Stock markets have declined sharply and volatility has been increased. On the basis that there are still quoted prices in an active market or are still observable, the increase in such volatility shall not change the manner in which fair value is measured at the reporting date. Further, incorporating such increase in volatility into valuation models may pose challenges to entities. While volatility in the financial markets may suggest that the prices are aberrations and do not reflect fair value, it would not be appropriate for an entity to disregard market prices at the measurement date, unless those prices are from transactions that are not orderly. The concept of an orderly transaction is intended to distinguish a fair value measurement from the price in a distressed sale or forced liquidation.

It is permitted to apply an appropriate valuation technique to measure the fair value of financial assets. However, such values calculated and used as the fair value in the financial statements for the period 2019/2020 by using different valuation techniques are not expected to exceed the market value reported as at 31st December 2019. Specifically, the rates considered in 31 December 2019 financial statements may be continued to be use in the 30 March 2020 reporting for the government foreign currency bonds.

Alternative method of valuations could be applied 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.

02. Impairment of Assets

Impairment of assets require an entity to assess at the end of each reporting period whether there is any indication that non-financial assets may be impaired (LKAS 36.12). The impairment test only has to be carried out if there are such indications and need to estimate the recoverable amount of the asset. This assessment has become even more critical with the COVID 19 condition.

Measurement of recoverable amount involves certain level of estimates and judgment. Fair value less costs to sell depends on the fair value measurement and the value in use requires several estimates of the future expected cash flows. Further, the entities may elect to measure the recoverable amount as the higher of the fair value less cost to sell or value in use and it is not always necessary to determine both provided that one of those exceeds the recoverable amount (LKAS 36.19).

Changes in the fair value has an impact on the measurement of the impairment since fair value less cost to sell is one measurement used to measure the recoverable amount of any assets. LKAS 36.25-29 of provides guidance on the measurement of fair value less cost to sell. In addition, value in use estimates the future cash flows expected to be derived from such asset's continuing use of the asset and from its ultimate disposal applying the appropriate discount rate to those future cash flows (LKAS 36.6) Accordingly, measurement of value in use involves significant estimates which will be reflected in the computation also get impacted from this outbreak situation. LKAS 36.30 provides certain elements that shall be reflected in the computation which include the following:

- Uncertain future cash flows
- Uncertain timing factor
- Fluctuating market interest rates due to the prevailing situation
- Uncertain time value of money
- Foreign exchange rate fluctuations.
- High judgmental application for the forecasting production, sales quantities.

In addition, LKAS 36.134(f) states that an entity needs to disclose reasonably possible changes in the key assumptions with the value assigned to those assumptions on which the management has determined its recoverable amount that would cause the carrying amount to exceed its recoverable amount.

The current development in this pandemic may show evidence on the internal and external sources of impartment indicators. Decline of the stock market, decrease in interest rates, reduction in the market commodity prices, import and export barriers and lockdown situation of the economies are some of the external indications that provide evidence on the need to do an assessment for impairment. On the other hand, the idling of assets, non-moving stocks, non-operating properties and other manufacturing plants, less production and drop in the selling prices will create a need to test the impairment from the internal side. Even though the cost has not changed, there is a possibility of recoverable amount to come down since many of the organisations will result in significant drops in performance that would lead to reductions in the forecasts used in the value in use calculations. On the other hand, fair value figures as at the reporting date would also be impacted. However, the impact of this particular circumstance could be considered as temporary trigger for impairment supported with the planned relief measures as well. In addition, the most of the non-financial assets would last for a longer term in the financial statements. Accordingly, this event alone won't provide impairment indications which require to assess the recoverable amount.

Since the measurement of the impairment will get highly impacted by this uncertain environment, it is necessary for the preparers to make adequate disclosures with the special attention on the application of estimates and the evidences, that the entity has based for these estimates and any significant assumptions made.

Challenges in estimating cash flows:

Estimating future cash flows could be particularly challenging for many companies due to the increase in economic uncertainty:

- Under value in use, cash flow projections shall be based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset or CGU. Greater weight is given to external evidence. (LKAS 36.33(a))

- In assessing the fair value, the estimates and assumptions used are from the perspective of market participants (SLFRS 13.22).

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. To cushion the economic and financial market impacts, governments in certain regions and international organisations have committed to fiscal stimulus, liquidity provisions and financial support. It is important 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. (LKAS 36. A1, A16, A18)

In addition, an entity may also make detailed disclosures on the application of fair value measurement basis due to this situation and the probability usage of value in use under multiple scenarios and the key assumptions and judgments used for each scenario thereon. Accordingly, there is a need to provide detailed disclosures on the assumptions made relating to the long-term use and impact on assets, supported by sensitivity analyses. In addition, entities may need to do the forecasting under multiple scenarios to reflect the possible current and future economic situations than relying on a single estimate as the value-in-use measurement.

03. Going Concern

Disruptions in the supply chain, logistics and other significant changes in demand can have implications for the working capital of an entity and resulting liquidity issues that affect the going concern in its operations. Many companies would need to adjust the way they manage liquidity to respond to the current market turmoil, including the use of alternative sources of funding which would cause significant doubt on the going concern of such entity.

When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern (LKAS 1.25). Further, in assessing whether the going concern assumption is appropriate, management considers all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period (LKAS 1.26). When making that assessment, management takes into consideration the existing and anticipated effects of the COVID 19 outbreak on the entity's business activities in its assessment of the appropriateness of the use of the going concern basis considering a period as far as possible that goes beyond 12 months. It is considered the COVID 19 condition is temporary. For example, when an entity has a history of profitable operations and relies on external financing resources, but because of the outbreak, its operations have been temporarily suspended before or after the reporting date, management would need to consider a wide range of factors relating to the current adverse situation including, expected impact on liquidity and profitability before it can satisfy itself that the going concern basis is appropriate. In the event, there are any plans to permanently curtail the business activities or go ahead with closure of business the going concern assumption may be inappropriate.

This assessment needs to be performed up to the date on which the financial statements are issued. When management assesses the entity's ability to continue as a going concern, it will need to consider the current economic uncertainty and market volatility caused by the COVID 19 outbreak. A company also needs to explain how it is managing this risk, including any changes from the previous period and any concentrations of liquidity risk. Disclosures addressing these requirements may need to be expanded, with added focus on the entity's response to the impact of COVID 19 (SLFRS 7.33).

Examples of specific disclosures required include:

- an explanation of how the entity manages liquidity risk; and
- disclosures of defaults and breaches relating to the borrowings recognised during and at the end of the reporting period (SLFRS 7.18–19, SLFRS 7.39(c)).

Accordingly, given the significance and widespread impact of COVID 19, expanded disclosures may be necessary in the financial statements.

Therefore, all available information shall be considered about the future, which could be obtained after the reporting date including measures taken by the government and banks to provide relief to affected entities in their assessment of going concern. In this context, following actions could be taken by the management:

- Update forecasts and sensitivities, as considered appropriate, considering the risk factors identified and the different possible outcomes. It is important to consider downside scenarios such as impact of lockdown when relevant.
- Review projected loan covenant compliance in different scenarios and therefore the related implications on availability of future funding.
- Assess its plans to mitigate events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Management would be expected to reassess the availability of finance. The entity needs to assess whether its plans are achievable and realistic.

For example, for 31 December 2019 financial statements and beyond, the entities that are severely affected by COVID 19, even though the significant impact on operations occurred after the year end, it will be necessary for management to consider the appropriateness of preparing financial statements on a going concern basis.

It will be critical for management to assess the impact the current events and conditions will have on entity's operations and forecasted cash flows, with the key issue being whether an entity will have sufficient liquid cash flows to continue to meet its obligations as they fall due. The management should reassess the availability of finance because it may not be easily replaced, and the costs may be higher in the current circumstances of COVID 19 outbreak. If management concludes that the consequences of the outbreak will result in a deterioration in operating results and financial position after the reporting date that is so severe that the going concern assumption is no longer appropriate, then the financial statements would need to be adjusted by changing in the going concern assumption is considered as an adjusting event.

Given the unpredictability of the potential impact of the outbreak, there may be material uncertainties that cast significant doubt on the entity's ability to operate under the going-concern basis. If the entity, nevertheless, prepares the financial statements under the going-concern assumption, it is required to disclose these material uncertainties in the financial statements in order to make clear to readers that the going-concern assumption used by management is subject to such material uncertainties. Additional disclosures will be needed, explaining the changes and how the company manages its liquidity in these difficult economic conditions.

The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, such entity may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate. The degree of consideration required, the conclusion reached, and the required level of disclosure will depend on the facts and circumstances in each case, because not all entities will be affected in the same manner and to the same extent. Significant judgement and continual updates to the assessments up to the date of issuance of the financial statements may be required given the evolving context.

04. Events After the Reporting Period

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.

Further, 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 (LKAS 10.21). 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 each material category of non-adjusting event after the reporting period:

For entities that are affected, or expect to be impacted by the outbreak or by the counter measures taken, judgement has to be exercised by the management on whether and, if so, what events will provide evidence of the conditions that existed at the end of the reporting period to indicate the impact on the entity's activities or its assets and or liabilities. When making this judgement, the entity needs to take into consideration all available information about the nature and the timeline of the COVID 19 outbreak and counter measures taken.

If the management concludes that an event as a non-adjusting event, but the impact of it is material, the entity is required to disclose the nature of the event and an estimate of its financial effect. For example, qualitative and quantitative factors need to be evaluated on how the market volatility subsequent to the year-end has affected its equity investments and governmental measures imposed and border controls that have affected or may affect its operations. If such an estimate cannot be made reliably, then the entity is required to disclose that fact.

On this basis, the effects of the coronavirus could be concluded generally:

- as a 'non-adjusting event' for entities with annual reporting date as at 31 December 2019 and therefore 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 coronavirus outbreak unless existence of a condition can be clearly demonstrated.
- for reporting periods ending thereafter (eg: for financial periods ending 31st March 2020)**,** 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.

05. Recognition of Deferred Taxes

COVID 19 could have impacted the entity's future profits and in turn impact the amount of deferred tax assets and liabilities that can be originated or recovered due to origination or reversal of deductible temporary differences.

A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized (LKAS 12.24). A deferred tax asset shall be recognised for the carried forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized (LKAS 12.34).

It is important for an entity to assess the effect of the changes that may have to be made to the profit projections or future forecasts due to the business implications and probability of recoverability of deferred tax assets recognized based temporary differences. Further, there could be any impact on the plans not to distribute the profits of subsidiaries, which might require entity to reconsider recognition of any deferred tax liability in such circumstances. In addition, in the current circumstances, an entity's projections of future taxable profits may be affected by:

- changes in forecast cash flows – e.g. expected decrease in production or sales prices with the increase in costs;
- relief packages offered by the government / financial institutions
- changes in tax strategies of the entity; 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, additional tax deductions, a reduced tax rate etc

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.

06. Lease Modifications

Certain local authorities have provided subsidies (rent concessions) and other relief measures to lessees and these payments are accounted for under LKAS 20. However, it is necessary to evaluate whether SLFRS 16 applies when such subsidised payments (rent concessions) made by a lessor and payments are received by a lessee. Accordingly, both lessee and lessor need to evaluate as to whether there is a lease modification by considering the original terms and conditions of the lease.

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease as per SLFRS 16. For a lease modification that is not accounted for as a separate lease, at the effective date of the lease modification, a lessee is required to allocate the consideration in the modified contract, determine the lease term of the modified lease and remeasure the lease liability by discounting the revised lease payments using a revised discount rate. If the modification decreases the scope of the lease, the lessee accounts for the remeasurement of the lease liability by decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease and recognises any gain or loss relating to the partial or full termination in profit or loss. For all other modifications, the lessee makes a corresponding adjustment to the right-of-use asset (SLFRS 16.44 – 46).

Option 01:

As per the SLFRS 16, in assessing whether the lease is modified, entities need to carefully evaluate terms of their contracts, including any force majeure clauses, which may, in specified circumstances, suspend some of their obligations or provide additional rights in the lease. Such modification requires the remeasurement of the lease liability using a revised discount rate. If the interest rate implicit in the lease is not readily determinable by the lessee, it is necessary for the lessee to determine a revised incremental borrowing rate. Accordingly, entity needs to reconsider about the below data to compute revise incremental borrowing rate.

- Risk free rate;
- Current borrowing rates (Weighted Average Cost of Capital, excluding cost of Equity) of the company;
- Credit rating of the company;
- Borrowing rates of the comparable companies with a similar term

The coronavirus outbreak has exacerbated market volatility and central bank interest rates. Assessing a revised incremental borrowing rate may also require judgement in these circumstances to remeasure the lease liability.

Option 02

As a practical expedient given in ED (COVID 19-Related Rent Concessions Proposed amendment to IFRS 16), a lessee may elect not to assess whether a COVID 19 related rent concession is a lease modification. A lessee that makes this election shall account for any change in lease payments resulting from the COVID 19 related rent concession in the same way that it would account for the change applying this standard if the change was not a lease modification.

The practical expedient applies only to rent concessions occurring as a direct consequence of the COVID 19 pandemic and only **if all of the following conditions** are met:

(a) the change in lease payments results in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change;

(b) any reduction in lease payments affects only payments originally due in 2020 (for example, a rent concession would meet this condition if it results in reduced lease payments in 2020 and increased lease payments that extend beyond 2020); and

(c) there is no substantive change to other terms and conditions of the lease.

(Exposure Draft ED/2020/2 - 46A - 46B)

Annexure: Interest Recognition under moratorium for performing loans

This clarification is provided on the understanding provided by the CBSL that during the moratorium period, no interest would be charged from the borrowers whatsoever and the originally scheduled repayments would be deferred by the period of moratorium without the borrower being required to make any additional payment in any manner. If there is any change on operational structuring such adjustments need to be adjusted accordingly, as agreed with the regulator.

Facts on the Example on Applying the Moratorium in Recognising the Interest in a Financial Institution:

Loan grant date	1-Apr-19
Loan amount	2,000,000
Term (original)	24 months
Interest Rate	16%
Installment value (derived)	97,926

Moratorium is for 6 months as stated in the Circulars issued by CBSL in March, 2020

Illustration 1:
Loan Amortisation Schedule (without moratorium)

Month	Principal o/s at the beginning	Interest for the month	Payment of Installment	Total o/s at the end
Apr-19	2,000,000	26,667	(97,926)	1,928,740
May-19	1,928,740	25,717	(97,926)	1,856,531
Jun-19	1,856,531	24,754	(97,926)	1,783,358
Jul-19	1,783,358	23,778	(97,926)	1,709,210
Aug-19	1,709,210	22,789	(97,926)	1,634,073
Sep-19	1,634,073	21,788	(97,926)	1,557,935
Oct-19	1,557,935	20,772	(97,926)	1,480,781
Nov-19	1,480,781	19,744	(97,926)	1,402,599
Dec-19	1,402,599	18,701	(97,926)	1,323,374
Jan-20	1,323,374	17,645	(97,926)	1,243,092
Feb-20	1,243,092	16,575	(97,926)	1,161,741
Mar-20	1,161,741	15,490	(97,926)	1,079,304
Apr-20	1,079,304	14,391	(97,926)	995,769
May-20	995,769	13,277	(97,926)	911,120
Jun-20	911,120	12,148	(97,926)	825,342
Jul-20	825,342	11,005	(97,926)	738,420
Aug-20	738,420	9,846	(97,926)	650,339
Sep-20	650,339	8,671	(97,926)	561,084
Oct-20	561,084	7,481	(97,926)	470,639
Nov-20	470,639	6,275	(97,926)	378,988
Dec-20	378,988	5,053	(97,926)	286,115
Jan-21	286,115	3,815	(97,926)	192,004
Feb-21	192,004	2,560	(97,926)	96,638
Mar-21	96,638	1,289	(97,926)	(0)
Total Interest Income and Impact to P&L (Cr) from 1 April 2020 onwards		**95,810**		

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Illustration 2:
Loan Amorisation Schedule where the modification is considered as substantial, then the loan is treated as a new loan derecognising the original loan

Capital Outstanding as at 01st April 2020	1,079,304
New IRR of the loan	8.22%

Month	Principal o/s at the beginning	Interest for the month	Payment of Installment	Principal o/s at the end
Apr-20	1,079,304	7,393	-	1,086,697
May-20	1,086,697	7,443	-	1,094,140
Jun-20	1,094,140	7,494	-	1,101,635
Jul-20	1,101,635	7,546	-	1,109,180
Aug-20	1,109,180	7,597	-	1,116,778
Sep-20	1,116,778	7,649	-	1,124,427
Oct-20	1,124,427	7,702	(97,926)	1,034,202
Nov-20	1,034,202	7,084	(97,926)	943,360
Dec-20	943,360	6,462	(97,926)	851,895
Jan-21	851,895	5,835	(97,926)	759,804
Feb-21	759,804	5,204	(97,926)	667,082
Mar-21	667,082	4,569	(97,926)	573,725
Apr-21	573,725	3,930	(97,926)	479,729
May-21	479,729	3,286	(97,926)	385,088
Jun-21	385,088	2,638	(97,926)	289,800
Jul-21	289,800	1,985	(97,926)	193,858
Aug-21	193,858	28	(97,926)	97,260
Sep-21	97,260	666	(97,926)	0
Total Interest Income and Impact to P&L (Cr)		**95,810**		

Illustration 3:
Loan Amorisation Schedule where the modification is considered as not substantial and accounted as a modification in the original loan

Original Loan Outstanding as at 1 April 2020	1,079,304
At the original rate the PV of the loan as at 1st April 2020 is	996,850
1,079,304/(1+0.16/12)^6	
Accordingly the day 1 loss of (1,07,304 - 996,850) has to be charged	82,454

Month	Principal o/s at the beginning	Interest for the month	Payment of Installment	Principal o/s at the end
Apr-20	996,850	13,291	-	1,010,142
May-20	1,010,142	13,469	-	1,023,610
Jun-20	1,023,610	13,648	-	1,037,258
Jul-20	1,037,258	13,830	-	1,051,089
Aug-20	1,051,089	14,015	-	1,065,103
Sep-20	1,065,103	14,201	-	1,079,304
Oct-20	1,079,304	14,391	(97,926)	995,769
Nov-20	995,769	13,277	(97,926)	911,120
Dec-20	911,120	12,148	(97,926)	825,342
Jan-21	825,342	11,005	(97,926)	738,420
Feb-21	738,420	9,846	(97,926)	650,339
Mar-21	650,339	8,671	(97,926)	561,084
Apr-21	561,084	7,481	(97,926)	470,639
May-21	470,639	6,275	(97,926)	378,988
Jun-21	378,988	5,053	(97,926)	286,115
Jul-21	286,115	3,815	(97,926)	192,004
Aug-21	192,004	2,560	(97,926)	96,638
Sep-21	96,638	1,289	(97,926)	(0)
Total Interest Income		**178,264**		
Day 1 Loss (Charged to P&L)		(82,454)		
Net Impact to P&L (Cr)		**95,810**		

Note:
This clarification is provided on the understanding provided by the CBSL that, during the moratorium period, no interest would be charged from the borrowers whatsoever and the originally scheduled repayments would be deferred by the period of moratorium without the borrower being required to make any additional payment in any manner.

Disclaimer:

This financial reporting guidance note has been produced purely based on the available information as at the date of the issue of this document. As and when the new or latest information become available it is necessary to take those in to consideration in exercising estimates and judgements.