Financial Statements Reviews - Focused Reviews 2021

During the year, SLAASMB commenced focused reviews of financial statements as described in the Regulatory Activity report for 2021. Such reviews were approached focusing on specific themes in the financial statements of Specified Business Enterprises (SBEs) in the Banking, Insurance, Real Estate and Hotel sectors.

Based on the reviews conducted, we ascertained whether there were non-compliances with SLFRS/LKAS in respect of the selected theme in the financial information presented in the financial statements of SBEs.

In selecting the themes for the year 2021, we were guided by the findings from the reviews conducted during the preceding year as well as of the requirement to give equal weightage to the aspects of recognition and measurement requirements and also to presentation and disclosure principles. Accordingly, during the year 2021 we conducted our focused financial statement reviews on the following four financial reporting themes;

- Risk disclosures made by Banks in compliance with Sri Lanka Accounting Standard SLFRS 7, Financial Instruments: Disclosures.
- Disclosures made by Insurance Companies in compliance with Sri Lanka Accounting Standard SLFRS 4, Insurance Contracts.
- Fair value measurement and disclosures made in compliance with Sri Lanka Accounting Standard SLFRS 13, Fair Value Measurement by listed companies in the Real Estate sector.
- Disclosures made in respect of the going concern ability and impact of COVID-19 by listed companies in the Hotel sector.

1. Risk disclosures made in compliance with SLFRS 7 by Banks

1.1. Introduction

SLFRS 7 requires quantitative and qualitative disclosures to be made of the entity's exposure to credit risk, liquidity risk, and market risk, how those risks had arisen, the entity's objectives, policies and processes for managing the risks, and of the methods used by the entity to measure them.

The Banking sector was focused on as a priority sector in the annual plan of SLAASMB for the year 2021. Further, in the recent past, we have observed a higher number of findings relating to non-compliance with SLFRS 7 by financial institutions, resulting from the inadequate

disclosures made of the nature and extent of risks arising from the financial instruments to which the entities have been exposed to and on how the entities had managed such risks. Inadequacies in risk disclosures had also been within the top ten common findings of the year 2020. These reasons have made SLAASMB to select the risk disclosures in the banks as a focus area for financial statement reviews carried out during 2021.

1.2. Findings

During 2021, we reviewed the financial statements for the year ended 31 December 2020 of all banks incorporated in Sri Lanka focusing on the risk disclosures made. The banks reviewed comprised of 13 Licensed Commercial banks and 6 Licensed Specialized banks.

1.2.1. During the review of the financial statements, the following disclosures made were observed as good practices.

- All banks had presented information relating to risk disclosures in a manner that made it easier to compare with the items in the statement of financial position.

- Majority of the banks had disclosed the entity-specific risk management objectives, policies and processes adopted to identify changes in risks, manage such risks, factoring such changes into Expected Credit Loss (ECL) calculations and the methods and assumptions used in the ECL calculations.

- Majority of the banks had disclosed the manner in which they had incorporated forward-looking information into the determination of ECLs and the changes made to the estimating techniques and assumptions due to COVID - 19.

- Majority of the banks had chosen time bands with sufficient granularity when presenting maturity analysis under liquidity risk disclosures.

- Majority of the banks had disclosed the sensitivity analysis for interest rate risk and currency risk to which those banks were exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variables.

Based on our reviews, common deviations observed from Standards are shown in Figure 1.

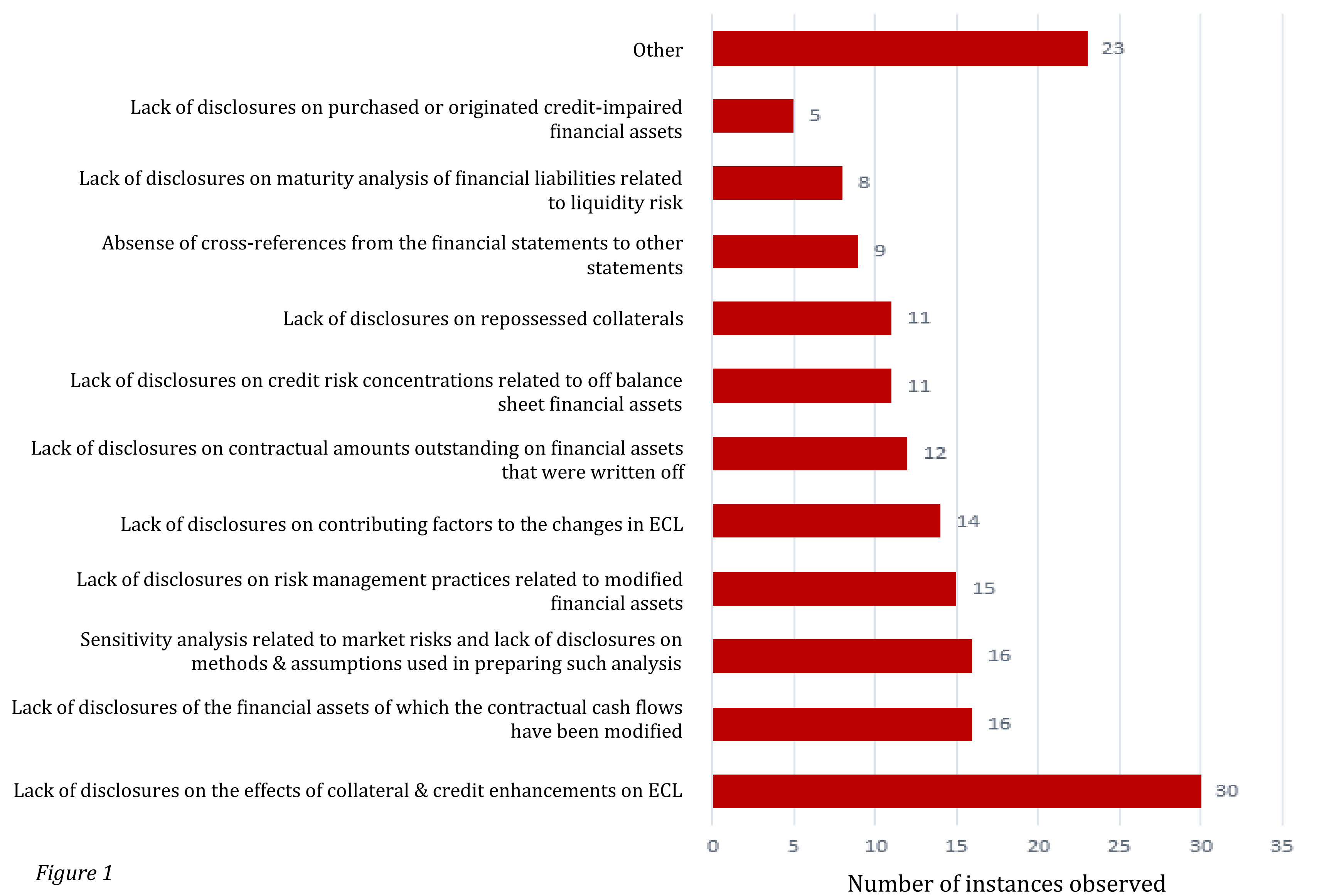

Figure 1

Of the commonly observed deficiencies, 54% were concentrated among the following 5 areas;

- Disclosures required to understand the effect the collateral and other credit enhancements have on the amounts arising from expected credit losses. Key findings relating to this area are as follows;
    - Not providing a narrative description of the significant changes in the quality of the collateral or credit enhancements, as a result of deterioration or changes in the collateral policies of the entity.
    - Inadequate disclosure on information about financial instruments for which an entity has not recognized a loss allowance because of the collateral.
    - Not disclosing quantitative information about the collateral held as security and other credit enhancements, for financial assets that are credit-impaired.
- Disclosures required to understand the nature and effect of modifications to contractual cash flows on financial assets that have not resulted in a derecognition.

  Key findings included not disclosing the amortized cost before the modification, the net modification gain or loss due to the modification and the gross carrying amount at the end of the reporting period, and disclosures on methods and assumptions used in preparing the sensitivity analysis.
- Providing a sensitivity analysis for a certain type of market risk (ex: equity price risk) to which the entity is exposed at the end of the reporting period and disclosures on methods and assumptions used in preparing the sensitivity analysis.
- Disclosure of the entity's restructuring and modification policies that are used to monitor the subsequent changes in the credit risk of modified financial assets and quantitative information to assist in understanding the subsequent increase in the credit risk of modified financial assets.
- Disclosures required to understand the contributing factors to the changes in the loss allowances during the period, including the information on how originations, acquisitions, and derecognitions of financial assets, and modification of contractual cash flows of financial assets, have contributed to the changes in the loss allowances.

2. Disclosures made in compliance with SLFRS 4 by Insurance Companies

2.1. Introduction

SLFRS 4 requires entities to disclose information about the amounts presented in their financial statements from insurance contracts. This includes information on accounting policies for insurance contracts and related assets, liabilities, income and expenses, the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts of assets, liabilities, income, expenses and cash flows arising from insurance contracts and the effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements.

Further, it requires an entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts. In order to achieve this, SLFRS 4 sets out a number of requirements that an entity should disclose.

Insurance sector was identified as one of the priority sectors to be subjected for review during the year 2021 mainly due to the higher involvement of management judgment and the estimation uncertainties when measuring insurance assets and liabilities and the importance the users of financial statements place on the comprehensive and quality disclosures in the financial statements.

Accordingly, the financial statements for the year ended 31 December 2020 of 24 insurance companies comprising of 12 life insurance companies, 10 General insurance companies and 2 composite insurance companies that had both life and non-life insurance, were reviewed during the year 2021 focusing on the disclosure requirements of SLFRS 4.

2.2. Findings

2.2.1 Based on the review findings, we observed insurance companies adopting the following informative disclosure practices as stated below;

- All companies had disclosed accounting policies for insurance contracts and related assets, liabilities, income and expenses at satisfactory levels. However, a few companies still have room to improve on the disclosures relating to product classification, by including the definition of investment contracts and the criteria for identification of insurance or investment contracts, with the Discretionary Participation Feature (DPF).

- All companies have disclosed recognised assets, liabilities, income and expenses and cash flows that arise from insurance contracts when the direct method has been used to present the Statement of cash flows.

- All companies have disclosed reconciliations of changes in insurance liabilities, reinsurance assets and, related deferred acquisition costs, if any. However, suggestions for improvements were communicated on the need to present separately, the income and expenses included in the profit or loss as premiums received and liabilities paid for death, maturities, surrenders, benefits and claims to a few life insurance companies.

2.2.2 The deviations from standards communicated to insurance companies are depicted in Figure 2.

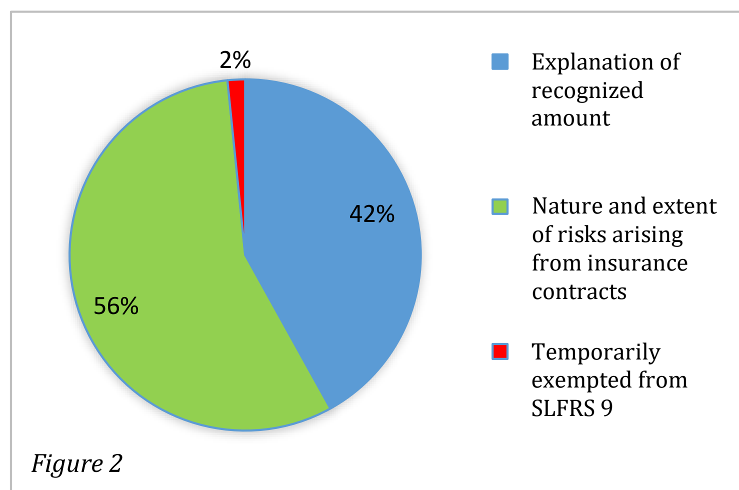

Figure 2

56% of the findings related to not disclosing the nature and extent of risks arising from insurance contracts and 42% related to not disclosing information relating to the amounts recognised in the financial statements from insurance contracts.

2.2.2.1. Main findings relating to the nature and extent of risks arising from insurance contracts included;

- Inadequate disclosure of the objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks, specially relating to the Asset and Liability Management (ALM) techniques.

- Inadequate quantitative disclosure such as sensitivity analysis that shows the effects on profit or loss and equity due to factors stated in paragraph 39A(a) or qualitative disclosure about the sensitivity and disclosure about the terms and conditions of insurance contracts that have an effect on the insurer's future cash flows.

- Inadequate disclosure made relating to information on credit risk, liquidity risk and market risk, i.e. information about credit risk, liquidity risk and market risk that paragraphs 31 to 42 of SLFRS 7, Financial Instruments: Disclosures would require, if the insurance contracts were within the scope of SLFRS 7.

2.2.2.2. Key findings in relation to the disclosure of information about the amounts recognized in their financial statements on insurance contracts were;

- Inadequate disclosures on the effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements.

- Inadequate disclosures on the process used to determine the assumptions that have the greatest effect on the measurement of the amounts recognised as per paragraph 37(b) of SLFRS4 including, the objective of the assumption and the source of data used as inputs for the assumptions that have the greatest effect.

3. Fair Value Measurement and disclosures made as required by SLFRS 13 by listed companies in the Real Estate sector

3.1. Introduction

With the impact of COVID -19 being anticipated to be more than short term, its outbreak has brought about unique challenges to entities when reporting on the fair values of their real estate properties. The impact of COVID -19 outbreak on fair value measurements and frequent findings by SLAASMB in relation to the application of SLFRS 13 by SBEs in the recent past, made us focus on fair value measurements by entities in the real estate sector during the year 2021.

3.2. Findings

During the reviews, we observed that all SBEs subjected to review in the real estate sector which had adopted the fair value model had obtained the services of experts to determine the fair values of their non-financial assets.

3.2.1. Based on the findings, we observed that SBEs had adopted following good practices.

- Most of the SBEs had obtained descriptive valuation reports with sufficient levels of documentation, to substantiate how they

had concluded the appropriateness of the fair values.

- Many SBEs had provided narrative descriptions of the sensitivities of their fair value measurements to changes in unobservable inputs.

3.2.2. The reviews also brought to light the following deviations in relation to fair value measurement and disclosure requirements as per SLFRS 13.

- Not measuring investment properties under construction at their fair values, when the Group's accounting policy is to measure investment property at fair value.
- Not disclosing quantitative information about the significant unobservable inputs used in the fair value measurement when such fair value measurements have been categorised under Level 3 of the fair value hierarchy.
- Not providing a description of the valuation technique and the inputs used in the fair value measurement.
- Making disclosure of information about the significant unobservable inputs which have not been used in the fair value measurement.
- When the valuation reports reflect the use of multiple valuation techniques in measuring the fair values, limiting the disclosure information only to a single valuation technique and to the unobservable inputs used in the said valuation technique.
- Disclosing unobservable inputs relating to a valuation technique that has not been used in determining the fair value.
- Disclosing unobservable inputs used in the corroborative valuation technique (reflected in the valuation report) together with the valuation technique used in determining the fair value measurement. This nature of disclosure could detract the ability of the users of the financial statements to understand the relevant unobservable inputs used in the fair value measurement.

4. Disclosure made in relation to Going Concern and impact of COVID-19 by listed companies in the hotel sector

4.1. Introduction

We observed the effects of COVID-19 witnessed in the economic conditions posing severe challenges to the hotel sector as well. As a result, entities in the

hotel sector have been operating under severe pressure and continue to be surrounded by high levels of uncertainty.

It is important that these financial statements include clear and comprehensive going concern disclosures. It helps the users to understand how companies intend to navigate through the pressures and uncertainties created by COVID-19. Therefore, the objective of our review was to provide useful guidance for preparers of financial statements by identifying areas where going concern disclosures could be improved.

We reviewed the financial statements for the year ended 31 March 2020 of 36 companies listed on the Colombo Stock Exchange whose principal business activity is in the hotel sector and focused on the going concern disclosures made by them.

We observed that going concern disclosures are often presented in numerous places within the Annual Reports and in assessing the quality of the going concern disclosures, we considered all such disclosures irrespective of where the said disclosures have been presented.

4.2. Findings

4.2.1. Based on the reviews, SLAASMB has observed comparatively better disclosures made by some companies as described below.

- Making company specific going concern disclosures.
- Providing additional information that clearly explained how COVID-19 had impacted the company's reported position and performance and how it could affect the future prospects.
- Providing more information to support management's assessment that reporting on a going concern basis is appropriate.
- Some companies have disclosed information in respect of the impact, the COVID-19 outbreak has on the going concern assessment, considering multiple stress-testing scenarios. These disclosures were useful as such disclosures highlighted the specific assumptions made and how management determined the assumptions applied, stress conditions, and the sensitivity and provided further insights on

the adequacy of funding under each stress condition.

4.2.2. Based on the observations, the following are common deficiencies observed in the disclosures made;

- Inadequate disclosures on the judgements used by the management:

  The majority of companies provided information about the scenarios they have considered when assessing their going concern. However, some reported scenarios have disclosed only generic information regarding the underlying assumptions. Disclosures presented are not company specific and the judgements made have not been identified clearly. Two such instances were observed where the adequate disclosures on the judgements that management had used in reaching its conclusion about their going concern had not been provided. These disclosures need to be improved by considering the existing and anticipated effect of the COVID-19 outbreak on the entity's business activities. In cases where management has determined that there is no material uncertainty to disclose, but has exercised significant judgements in forming that conclusion, the disclosures about the significant judgements required by paragraph 122 of LKAS 1 need to be presented.

- Inadequate disclosures on liquidity risk management of the company:

  Two instances were observed where adequate disclosures were not made as to how the company is managing its liquidity risks. The disclosures need to be improved by explicitly linking the scenarios to the risks and uncertainties that pose the greatest threat to the business model, future performance, solvency and liquidity of the company. Company and scenario specific details should be disclosed to enable the users to understand the risks that have been considered along with the related viability scenarios.

4.2.2.1. The results of the reviews of financial statements in the hotel sector are depicted in Figure 3.

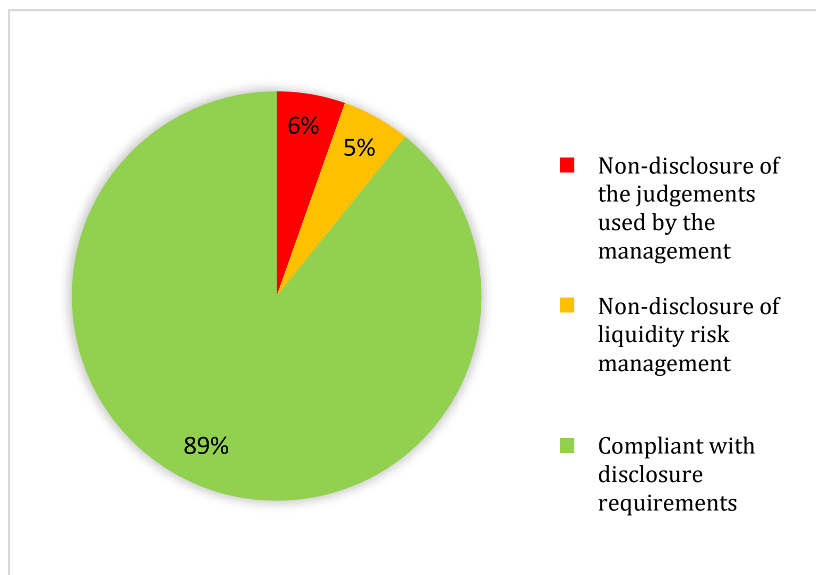

Figure 3

In addition to these two areas, entities are encouraged to present disclosures that provide reasons for the duration of the period assessed for going concern and to select a going concern assessment period that extends beyond the minimum stated in the requirements of LKAS 1, Presentation of Financial Statements, in cases where the use of a longer period provides more helpful information to the reader.

5. What we expect from communicating our findings

Having identified the good practices adopted by entities in relation to the four aspects focused in the reviews as stated above as well as the deviations from the respective SLFRS/LKAS, we at SLAASMB, look forward to entities and their auditors taking steps to improve on the above disclosures in their financial reports. This effort will help to enhance the understandability of the financial statements in the future.