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TABLE OF CONTENTS

in association with:

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AUDIT • ADVISORY • FORENSICS

Technical queries email: technicalandstandards.org.za

OPPORTUNITY. EXCEEDED.

1. NOTES FROM THE EDITOR

So much has happened this year already, and we found it necessary to share all the latest updates with you in this quarter's PAFA Technical Bulletin. In this issue you will find:

2. Insight to the new standard on Financial Instruments (IFRS 9) ;
3. An overview of the Draft Practise Statement issued on Materiality; and
4. A snapshot of the new leases standard (IFRS 16) from the lessee's perspective.

In the following quarter's PAFA Technical Bulletin we will issue a snapshot of the new leases standard from the lessor's perspective to ensure that you are informed on the developments to come and how to manage your expectations on the implementation of the standards. Please feel free to discuss any of the articles with us if you have additional questions or comments.

Happy reading!

Cynthia Mbili CA (SA); and Lotus Dzeke CA (SA)

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2. INSIGHT TO THE NEW STANDARD ON FINANCIAL INSTRUMENTS (IFRS 9)

2.1 Introduction

IFRS 9 Financial Instruments issued by the International Accounting Standards Board (IASB), sets out the requirements for recognising; measurement and derecognition of financial instruments. This Standard replaces IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 Financial Instruments is effective 1 January 2018, with early adoption being permitted. This article serves to provide insights on accounting for financial instruments from the new IFRS 9 perspective except for hedge accounting. In this article we start by discussing the changes in the scope of financial instruments, classification of financial instruments, impairment of financial assets, embedded derivatives, reclassification of financial instruments and conclude with the transition requirements. The following sections will not be discussed as they were generally carried through from IAS 39 to IFRS 9 without any significant changes:

- Initial recognition of financial assets and financial liabilities;
- Initial measurement of financial assets and financial liabilities;
- Derecognition of financial assets and financial liabilities; and
- Subsequent measurement of financial liabilities except for the "own credit risk".

2.2 The scope of financial instruments

In developing IFRS 9, the IASB decided that the current scope of IAS 39 be retained. Consequently, the scope of IAS 39 was carried forward to IFRS 9 with a few amendments. It has been changed only as a consequence of the new impairment requirements and the changes are discussed below.

2.2.1 Non-financial item contracts for own usage (own use exemption)

The scope of IAS 39 applies to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument,
or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into for own usage requirements.
Thus, non-financial item contracts for own usage (e.g. inventory for own manufacturing purposes) are outside the scope of IAS 39. However, the new IFRS 9 provides entities with a choice to account for such contracts (own use contracts) either under IFRS 9 by designating the contract to be a contract subsequently measured at FVTPL, or in accordance with the applicable standard. The choice to designate own use contracts in IFRS 9 is only allowed when doing so eliminates an accounting mismatch.

2.2.2 Trade receivables and/or contract assets

Trade receivables are normally non-interest-bearing because of their short maturity. The practical application of the impairment requirements in IAS 39 often results in credit losses not being recognised until trade receivables become past due. In finalising IFRS 9, the IASB concluded that requiring entities to recognise a loss allowance on a more forward-looking basis before trade receivables become past due would improve financial reporting. Therefore, the scope of IFRS 9 includes the impairment of trade receivables. In addition, the new IFRS 15 Revenue from Contracts with Customers refers to the receivable as a contract asset. This new revenue standard specifically states that an entity shall assess, measured, presented and disclosed impairment of a contract asset in accordance with IFRS 9. Therefore, the impairment of these contract assets are in the scope the new IFRS 9.

2.2.3 Loan commitments and financial guarantee contracts

Loan commitments and financial guarantee contracts outside the scope of IAS 39 are accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

In developing the single impairment model for all financial assets in IFRS 9, the IASB considered whether an entity should apply the same impairment model to loan commitments and financial guarantee contracts as for financial assets measured at amortised cost.

From its outreaches, the IASB noted that, expected credit losses on loan commitments and financial guarantee contracts (off balance sheet exposures) are similar to normal loans.

The only difference is that with normal loans, the borrower has already drawn down the loan whereas in loan commitments, the borrower has not drawn down. The IASB also noted that loan commitments and financial guarantee contracts are often managed using the same credit risk management approach and information systems as normal loans and other on balance sheet items.

Thus, the IASB concluded that a single impairment model for all credit exposures, irrespective of their type, should be applied. Therefore, loan commitments and financial guarantee contracts are within the scope of the impairment model of IFRS 9.

2.3 Classification of financial assets

IFRS 9 has three main principle based measurement categories for financial assets that are based on the business model approach. IAS 39 have four main measurement categories for financial assets that are based a mixed approach. The following table indicates the categories of financial assets under both, IFRS 9 and the current IAS 39.

IAS 39 Categories	IFRS 9 Categories
1. Financial assets at fair value through profit or loss (FVTPL)	1. Financial assets at fair value through profit or loss (FVTPL)
2. Held-to-maturity investments	2. Financial assets at amortised cost
3. Loans and receivables	
4. Available-for-sale financial assets	3. Financial asset at fair value through other comprehensive income (FVOCI)

2.3.1 The approach to the classification of financial assets

IFRS 9 requires an entity to classify financial assets on the basis of the entity's business model for managing the financial assets, unless if the entity opts to irrevocably designate. The business model is determined by the entity's key management personnel (as defined in IAS 24 Related Party Disclosures). An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective and does not depend on management's intentions for an individual instrument.

Accordingly, the business model approach is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes. Similarly, in some circumstances, it may be appropriate to separate a portfolio of financial assets into sub-portfolios in order to reflect the level at which an entity manages those financial assets.

Below is an illustration of the business model approach to classification and the related categories.

a If a financial asset is held within a business model whose objective is to hold financial assets in order to collect contracual cash flows and the contractual terms of the financial asset give rise on specified dates, t cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.	→	**The financial asset is measured at amortised cost.** Interest revenue calculated using the effective interest method. Interest reveneue, expected credit losses and gains or losses are recognised in profit loss.
b If a financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.	→	**The financial asset is measured at fair value through other comprehensive income (FVOCI)** Mainly for investment in an equity instrument that is not held for trading. Gains or losses are recognised in other comprehensive income. Dividentsand expected credit losses are recognaised in profit loss.
If a financial asset is held within any other business modell which is not **a** and **b** above	→	**The financial asset is measured at fair value through profit or loss (FVTPL)** Gains or losses are recognised in profit loss.

2.3.2 Contractual cash flows are solely payments of principal and interest (SPPI)

The business model approach to classification of financial assets requires an entity to determine whether the asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding. In accordance with paragraph 4.1.3(a) of IFRS 9, principal is the fair value of the financial asset at initial recognition. However that principal amount may change over the life of the financial asset (for example, if there are repayments of principal). The standard also explains that contractual cash flows are solely payments of principal and interest on the principal amount outstanding if they are consistent with a basic lending arrangement.

In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest.

However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. Therefore, during the business model assessment, an entity needs to assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

2.4 Impairment of financial assets

IAS 39 has multiple impairment models that are applied currently, whereas IFRS 9 introduces a single impairment model for all financial assets that are in the impairment scope.

The current impairment model in IAS 39 is referred to as the incurred loss model as it wants a loss event to happen or the impairment losses to be incurred for it to be recognised. IFRS 9 is replacing the incurred loss model with a forward looking expected loss model (ECL). An entity shall apply the impairment requirements to financial assets that are measured at amortised cost and to financial assets that are measured at fair value through other comprehensive income. Financial assets carried at fair value through profit or loss are not impaired.

The objective of the new Expected Credit loss impairment model is to enable entities to track instruments for which credit risk has increased significantly since initial recognition instead of waiting for the instruments to be credit impaired.

The new standard outlines a "three-stage" model for impairment based on changes in credit quality since initial recognition. The change in credit quality determines the category of the financial asset, that is, whether it is performing; under-performing or non-performing. When the financial assets are in the "performing stage", a 12 months expected credit loss should be determined. Once the credit quality of the financial assets deteriorate to push them to underperforming or Non-performing, a lifetime expected credit loss should be determined. The new impairment approach can be illustrated by the diagram below.

IMPAIRMENT APPROACH STAGES

STAGE 1

PERFORMING FINANCIAL ASSETS

- No significant increase in credit risk since initial recognition;
- A 12 months expected credit loss should be recognised,; and
- Interest revenue on the financial asset is caltulated using the Gross carrying amount of the financial asset (carrying amount before reducing with the impariment loss),

STAGE 2

UNDER-PERFOMING FINANCIAL ASSETS

- There is a significant increase in credit risk since initial recognition;
- A lifetime expected credit loss should be recognised; and
- Interest revenue on the financial asset is calculated using the Gross carrying amount of the financial asset (carrying amount before reducing with the impariment loss).

STAGE 3

PERFOMING FINANCIAL ASSETS

- In state 3, the financial asset is Credit impared;
- A lifetime expected credit loss should be recognised; and
- Interest revenue on the financial asset is caltulated using the Net carrying amount of the financial asset (carrying amount after reducing with the impairment loss)

At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. To make that assessment, an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition. The entity should consider reasonable and supportable information, that is available without undue cost or effort, which is indicative of significant increases in credit risk since initial recognition. An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date. The interest revenue on the financial assets is calculated by applying the effective interest rate to the gross carrying amount of the financial assets if the financial assets are in the Performing and the Underperforming state. When the financial assets are credit-impaired, calculate the interest revenue by applying the effective interest rate to the net carrying amount of the financial assets.

2.5 Embedded derivatives

IFRS 9 carries through the bifurcation criterial and the other embedded derivative requirements in IAS 39 without any changes except for derivatives embedded in financial assets. IFRS 9 specifies that, derivatives embedded in financial assets hosts should never be separated. Thus, the entire hybrid contract follows the business model classification approach. IAS 39 requires an embedded derivative to be separated from the host contract and accounted for as a derivative if the bifurcation criteria is met.

2.6 Reclassification of financial instruments

The IASB noted that the classification of financial assets under IFRS 9,

is based on a business model approach and hence decided that the reclassification of financial assets should also be informed by a change in the business model. Therefore, financial assets are reclassified when, and only when, an entity changes its business model for managing the affected financial assets. Consequently, when an entity changes its business model for managing financial assets, it must reclassify all affected financial assets. In addition to these reclassification requirements, all reclassifications into and out of the fair value through other comprehensive income measurement category are applied prospectively from the reclassification date and previously recognised gains or losses (including impairment gains or losses) or interest revenue are not restated. Although, IFRS 9 carried through the categories and the subsequent measurement of financial liabilities, it does not allow entities to reclassify financial liabilities. Therefore, no reclassifications of financial liabilities are performed after initial recognition.

2.7 Transitional requirements

An entity shall apply this Standard retrospectively, in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. IFRS 9 may appear to be a long time, however, it should be noted that the standard requires retrospective application. Comparative figures are required hence impact assessment and the adoption plan should be of great consideration now on going forward.

2.8 Conclusion

The articles has given overall insights on the new standard on Financial Instruments (IFRS 9). The IFRS 9 project was split by the IASB into three phases, which are, classification, impairment methodology and hedge accounting. Therefore, the articles has discussed the classification of financial assets which is now based on a business model approach. It also gave insights on the new impairment model which is a move from the incurred loss model to the expected credit loss model that is more forward looking.

3. AN OVERVIEW OF THE DRAFT PRACTISE STATEMENT ISSUED ON MATERIALITY

3.1 Update on the Materiality Project

The International Accounting Standards Board (IASB) has published an Exposure Draft (ED) of a proposed IFRS Practice Statement Application of Materiality to Financial Statements. The Draft Practice Statement proposes guidance to help management apply the concept of materiality when preparing general purpose financial statements in accordance with International Financial Reporting Standards (IFRS).

3.2 What is materiality from a preparer's point of view?

According to the Conceptual Framework for Financial Reporting, 'information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.'

Consequently, the concept of materiality acts as a filter through which management sifts information. This filter ensures that financial statements include all material information—ie the financial information that could influence users' investment decisions. That filter also enables management to present material information in a clear and effective manner by excluding information that is not material.

3.3 Why was guidance issued?

The IASB was informed at the Discussion Forum on Financial Reporting Disclosure in January 2013, and in its related survey and by other sources that poor application of materiality contributes to too much irrelevant information in financial statements and not enough relevant information. In the light of this feedback, the IASB decided to undertake a project on materiality.

The Draft Practice Statement is designed to be a tool to help management use their judgement about what information is material and therefore should be included in financial statements. It should also help facilitate management's discussions with auditors and regulators about those judgements.

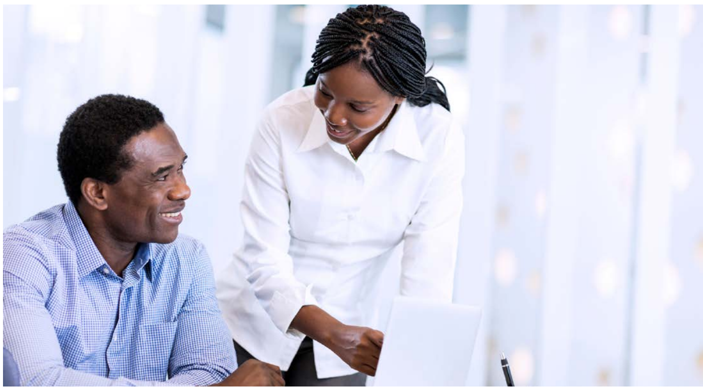
3.4 Does the guidance change the concept of materiality in IFRS?

The guidance does not change, or affect, the definition of materiality that is currently in IFRS. The Practice Statement also does not change an entity's obligation to disclose material information. The Draft Practice Statement discusses the characteristics of materiality, including the pervasiveness of the concept in IFRS; the importance of management's use of judgement; who the primary users of the financial statements are and what decisions they make based on those financial statements; the need for a quantitative and qualitative assessment when applying the concept; and the need to assess whether information is material, both individually and collectively.

The Draft Practice Statement also provides some guidance on applying the concept of materiality to the recognition and measurement requirements.

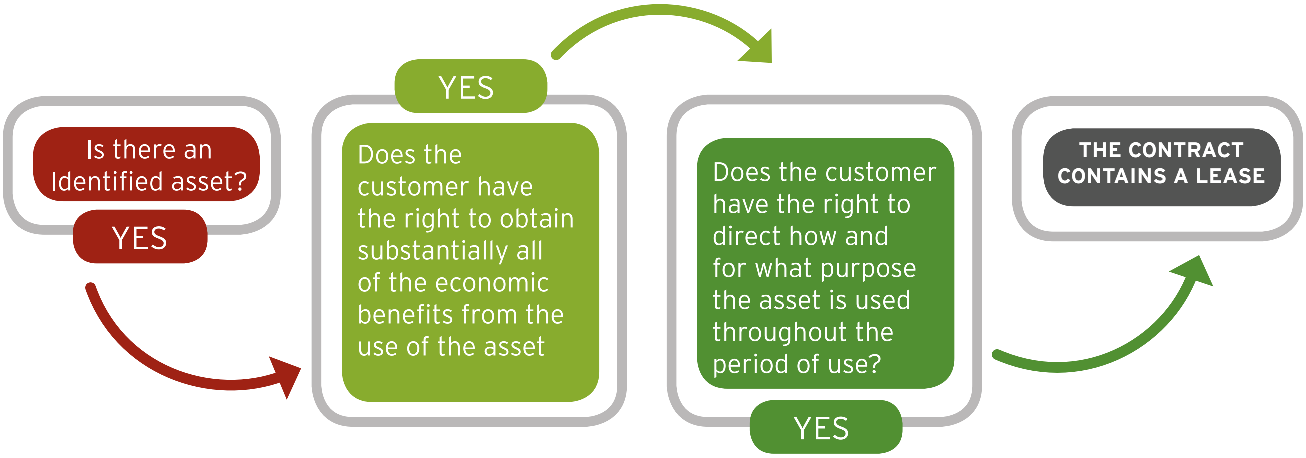
3.5 Our view on The Draft Practise Statement

We think the document will be helpful in reducing the disclosures made in financial statements and generally thought the guidance was useful. We believe that there is scope for us to assist boards to define their own concept of materiality and implement it in drafting and presenting their financial statements in a more concise manner.



(IFRS 16) FROM THE LESSEE'S PERSPECTIVE

- Snapshot Objective – to give a high level overview of the lessee perspective of the New Lease Model.
- Identifying a lease: A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for a consideration.



Conceptual Background

	Rights	Assets		Obligation	Liability	
		YES	NO		YES	NO
Lessee	Rights to receive right to use asset.	X		Obligation to make a payment	X	
				Obligation to return the asset		X

Initial Recognition

Right of use asset*	At the commencement date, a lessee shall measure the right of use asset at cost.
Lease liability	At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.

Subsequent Measurement

Right of use asset*	After commencement date lessee measures the right of use asset using the cost model unless: • Fair value IAS 40 Investment property applies; or • Revaluation model in IAS 16 Property, Plant and Equipment applies. Cost model =cost of the right of use asset less accumulated depreciation less/plus remeasurement of lease liability.
Lease liability	PV of lease payments plus interest less lease payments plus/less remeasurement of lease liability Remeasure the lease liability to reflect changes to the lease payment.

Recognition Exemption	Practical Expedients
• Short term leases	• Portfolio application
• Leases for which the underlying asset is of low value	• Combination of contracts

** Presentation and disclosure: either as a separate asset or as part of Property, plant and equipment*