RECENT DEVELOPMENTS IN IFRSs AND THEIR IMPACT ON TAXATION

THE 4th ANNUAL TAX CONVENTION

Presentation by:

CPA Stephen Obock
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Agenda

1. IFRS 15 Revenue from Contracts with Customers
2. IFRS 9 Financial Instruments
3. IFRS 16 Leases

IFRS 15 Revenue from Contracts with Customers

IFRS 15 replaces:

- IAS 11 Construction Contracts
- IAS 18 Revenue
- IFRIC 13 Customer Loyalty Programmes
- IFRIC 15 Agreements for the Construction of Real Estate
- IFRIC 18 Transfers of Assets from Customers
- SIC-31 Revenue – Barter Transactions Involving Advertising Services

IFRS 15 applies to annual periods beginning on or after 1 January 2018

The 5 step model overview

STEP 1 — **Identify the contract with a customer**

STEP 2 — **Identify the performance obligation**

STEP 3 — **Determine the transaction price**

STEP 4 — **Allocate the transaction price**

STEP 5 — **Recognise revenue**

Identify the contract

A contract exists if...

Parties approved it and are committed to their obligations.

It identifies:

- ✓ rights to goods or services and
- ✓ payment terms.

It has commercial substance.

Collection of consideration is considered probable.

Question: Does a contract exist?

- An equipment manufacturer (EM) sells parts to Group X, which operates across a number of countries
- EM contracts with the entity in each individual country/region
- Company A is part of Group X but is renowned for not settling its debts and has been making losses for the last two years
- EM has also heard through the grapevine that Company A is planning a retrenchment programme
- EM has supplied and invoiced Company A for parts worth CU100 000 on 1 March 2016
- The parts were signed for by Company A on 2 March 2016 and invoices are payable within 30 days

Does a contract exist?

Identify performance obligations

Performance obligation (PO) = promise to deliver good or service that is

Criterion 1: Capable of being distinct	+	**Criterion 2: Distinct within context of the contract**
Can the customer benefit from the good or service either on its own or together with readily available resources?		Promise to transfer the good or service is separately identifiable from other promises in the contract?

Yes → Distinct performance obligation

No → Not distinct – combined with other goods and services

Key facts

- Entities may be required to change the timing or amount of revenue reported in financial statements for a variety of reasons.
- The seller's price is no longer required to be fixed or determinable.
- Revenue may be recognized over time or at a point in time. In some cases, entities that currently recognize revenue upon delivery may recognize revenue over time and vis versa
- There are new requirements for capitalizing costs of obtaining or fulfilling a contract (e.g., sales commissions)
- There is new gross versus net revenue guidance that may change the gross/net analysis for some entities.

Tax implications

- Accelerating taxable income because tax accounting methods change;
- Creating or changing existing temporary differences in accounting for income taxes for financial reporting purposes;
- Requiring revisions to transfer pricing strategies and documentation;
- Requiring updated policies, systems, processes, and controls surrounding income tax accounting and financial accounting; and

Tax implications

- Possible impact on VAT or excise taxes because revenue may be recharacterized between product and service revenue.

- **Transfer Pricing-** Changes to the amount and timing of revenue recognition from the new revenue recognition standard may have a significant effect on transfer pricing specifically as it relates to using revenue or profit-based methods for establishing the transfer pricing. An entity may need to consider whether its transfer pricing strategies and supporting documentation should be revised or updated.

IFRS 9

Impairment – the new mo

Expected loss model

=

Past events

+

Current conditions

+

Forecast of future economic conditions

WHAT'S NEW?

Impairment - high level overview

EL = PD x LGD x EAD

EL

- Expected loss is a statistical measure used to reflect expectations of future losses based on historical data
- The three primary components are derived based on observation, empirical evidence and expert judgment
- The objective is to quantify loss expectations over a 12 month forecast

PD

- Probability of default for an asset or class of assets over the next year
- PD represents an average expectation over the course of an entire business cycle (through-the-cycle) as opposed to specific current expectations (point-in-time)

LGD

- Loss given default based on losses resulting from defaults over the next 12 months
- Ideally the LGD will be separated for secured and unsecured portions of an exposure
- LGD is a prudent parameter based on an assumed downturn in the economic conditions

EAD

- Exposure at default represents the amount a financial institution stands to lose in the event of a default event
- For a 12 month horizon, the EAD is defined as the current exposure without considering payments
- Undrawn commitments are factored in using statistical probabilities of drawing

- Changes to existing models are necessary to comply with lifetime expected credit loss (LECL) requirements

IFRS 9 ECL – General mode

Significant increase in credit risk (credit deterioration) since initial recognition

Impairment recognition

Stage 1	Stage 2	Stage 3
12-month expected loss	Lifetime expected loss	Lifetime expected loss

Interest revenue recognition

Stage 1	Stage 2	Stage 3
EIR on gross amount (excl loss allowance)	EIR on gross amount (excl loss allowance)	EIR on amortised cost (net of loss allowance)

Stage 1
Performing
"The Good"

Stage 2
Under-Performing
"The Bad"

Stage 3
Non-Performing
"The Ugly"

EIR: Effective interest rate

12-month ECLs are the portion of lifetime expected credit losses that represents losses resulting from default events that are possible within 12 months

Lifetime ECLs are the expected credit losses that result from all possible default events over the expected life of a financial instrument

Impairment Model – Gene model (continued)

Impairment recognition

Credit quality deterioration since initial recognition

Transfer of **individual assets** when

- No longer **Investment Grade** and
- **Significant increase in PD** since origination

Transfer of **individual assets** from stage 2 to stage 3 when **impairment triggers** are observed

12-month ECL	Lifetime ECL	Lifetime ECL
Stage 1 Performing	**Stage 2** Under-Performing	**Stage 3** Non-Performing

IAS 39 versus IFRS

Parameter	IAS 39 Incurred Loss Model	IFRS 9 Expected Loss model
Expected Loss (EL) or Incurred Loss (IL)	• IL = EAD × PD × LGD × EP	• EL = EAD × PD× LGD
Emergence Period (EP)	• EP attempts to strip out the incurred portion from expected loss.	• Not applied
Exposure At Default (EAD)	• Includes the assets carrying value at reporting date (exclude future exposure)	• Includes credit conversion factors (CCF's) for unutilised facilities.
Probability of Default (PD)	• Point-In-Time (PIT) PD or a roll rate approach. • Usually done using a 1 year outcome period and adjusting for incurred loss via the EP.	• 12m PD (to estimate 12m EL for performing assets) • Lifetime PD (to estimate lifetime EL for underperforming assets)
Loss Given Default (LGD)	• Point-In-Time (PIT) LGD. • It should reflect expectations in terms of recovery cash flows due to credit cycle effects.	• Lifetime LGD should be considered through the life of the assets.

Practical example

Example of IAS 39 vs IFRS 9- consider a 5 year loan

The table below provides an overview of the PD and EAD assumptions:

	PD	EaD	EL
1 Yr	2.5%	K1 000.00	K 7.50
2 Yr	2.4%	K 800.00	K 5.85
3 Yr	2.4%	K 600.00	K 4.28
4 Yr	2.3%	K 400.00	K 2.79
5 Yr	2.3%	K 200.00	K 1.36
Total			**K 21.78**

LGD is assumed to be 30% through out the life of the loan, and the emergence period is 3 months (i.e. 25% EP adjustment).

The provision estimate under IFRS 9 is expected to be higher than the requirements under IAS 39. For this example, the main reasons for the higher loss allowance under IFRS 9 are due to:

- Incurred vs. expected loss estimate; and Lifetime EL for underperforming loans (bucket 2).

Practical example

Example of IAS 39 vs IFRS 9

Scenario 1: performing- Loan is up-to-date, and there is no indictors suggesting that the loan is under- performing

- *IAS 39 – classified as general provision – incurred but not expected*
- *As per the example above IAS 39 provision is **K7.50*25% = K1.88***
- IFRS 9 – classified as bucket 1: 12 month expected loss
- *As per the example above IFRS 9 provision is **K 7.50***

Scenario 2: Under-performing- Loan is not in arrears, but there is indicators suggesting the loans is under-performing

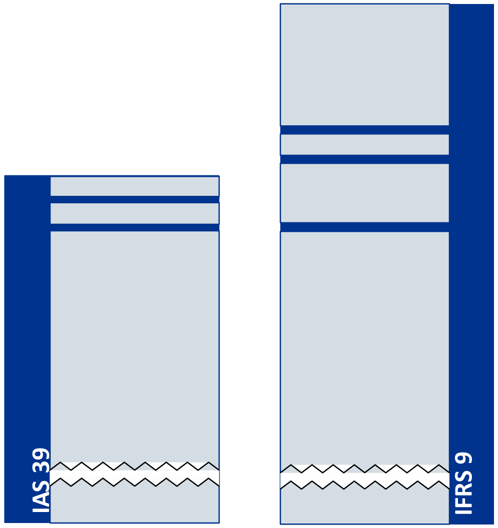
- IAS 39 – classified as general provision – incurred but not expected
- *As per the example above IAS39 provision is **K7.50*25% = K1.88***
- IFRS 9 – classified as bucket 2: Life time expected loss
- *As per the example above IFRS 9 provision is **K21.78***

Practical example

Example of IAS 39 vs IFRS

Scenario 3: Under-performing-Loan is in arrears (under performing) but not in default

- IAS 39 – classified as general provision – special mention
- *As per the example above IAS39 provision* ***is K7.50***
- IFRS 9 – classified as bucket 2: Life time expected loss
- *As per the example above IFRS 9 provision* ***is K21.78***



Tax implications

- IFRS 9 does not impact on specific impairment provisions, the impact will result into an increase in the stage 1 and stage 2 provision which are general provisions.

Impact

- Potentially no impact on corporation tax- the provisions will be added back in the tax computations
- Increase in provisions will result into an increase in deferred tax asset especially in the first year of adoption

IFRS 16 -Leases

More transparent lease accounting

"IFRS 16 will bring most leases on-balance sheet from 2019. All companies that lease assets for use in their business will see an increase in reported assets and liabilities.

This will affect a wide variety of sectors, from airlines that lease aircraft to retailers that lease stores. The larger the lease portfolio, the greater the impact on key reporting metrics."

Lessees face major changes

All major leases on balance sheet

Balance sheet

Asset

= 'Right-of-use' of underlying asset

Liability

= Obligation to make lease payments

P&L

Lease expense

Depreciation

+ Interest

= Front-loaded total lease expense

Measuring the lease liability

Lease liability = Present value of lease rentals + Present value of expected payments at end of lease

- **Key inputs**

Lease term

Lease payments

Discount rate

Measuring the right-of-use (ROU) asset

ROU asset

=

Lease liability + Initial incremental direct costs + Prepaid lease payments + Costs to dismantle or restore (IAS 37) – Lease incentives

Subsequent measurement

Lease liability	▪ Amortised cost using the effective interest method ▪ Cannot be measured at FVTPL/FVOCI.
ROU asset (cost model)	▪ Depreciated in accordance with IAS 16 *Property, Plant & Equipment*. ▪ Depreciation period is the shorter of lease term/useful life. ▪ Impairment testing under IAS 36 *Impairment.*
ROU asset (alternative models)	▪ Revaluation model under IAS 16. ▪ Fair value model under IAS 40 *Investment Property.*

Lessor Accounting

Finance Lease	Operating Lease
Statement of Financial Position	
• Derecognise the underlying asset • Recognise a finance lease receivable	• Continue to present the underlying asset • Add any initial direct costs incurred
Statement of Profit or Loss	
• Recognise finance income on the receivable based on effective interest method	• Recognise lease income over the lease term (typically straight-line) • Expense costs related to underlying asset (eg depreciation)

Tax implications of IFRS 16

Currently, that the lessor claims capital allowance at the prescribed rate on assets on operating lease while the lessee claims capital allowance on assets finance lease.

Given that IFRS 16 does not change the definition of both terms (finance lease and operating lease), it may be easy to conclude that nothing much will change from a tax perspective.

Using current tax provisions, where a lease under the terms of the transaction qualifies as an operating lease, the lessor will continue to claim capital allowance on the asset throughout the duration of the lease.

However, under the IFRS 16, the lessee would have capitalized the same asset, recognised a depreciation expense and an interest expense.

Tax implications of IFRS 16

It is expected that, the depreciation expense would be disallowed and given that the lease remains an operating lease despite the new basis for recognition and accounting, it can be argued that the lessee will not be able to claim capital allowances on the value of the asset recognised.

This would therefore serve as double jeopardy for the lessee. It would only be fair for the lessee to be allowed to claim capital allowances.

Expectations….

- The tax agents are expected to have an appreciation of the requirements of the new IFRSs and their impact on tax.

Interactive Session