Tax Matters and Emerging Issues Seminar for ICPAK North Eastern Branch

Recent developments in accounting and their impact on taxation: IFRS 9 and other standards

Presentation by:

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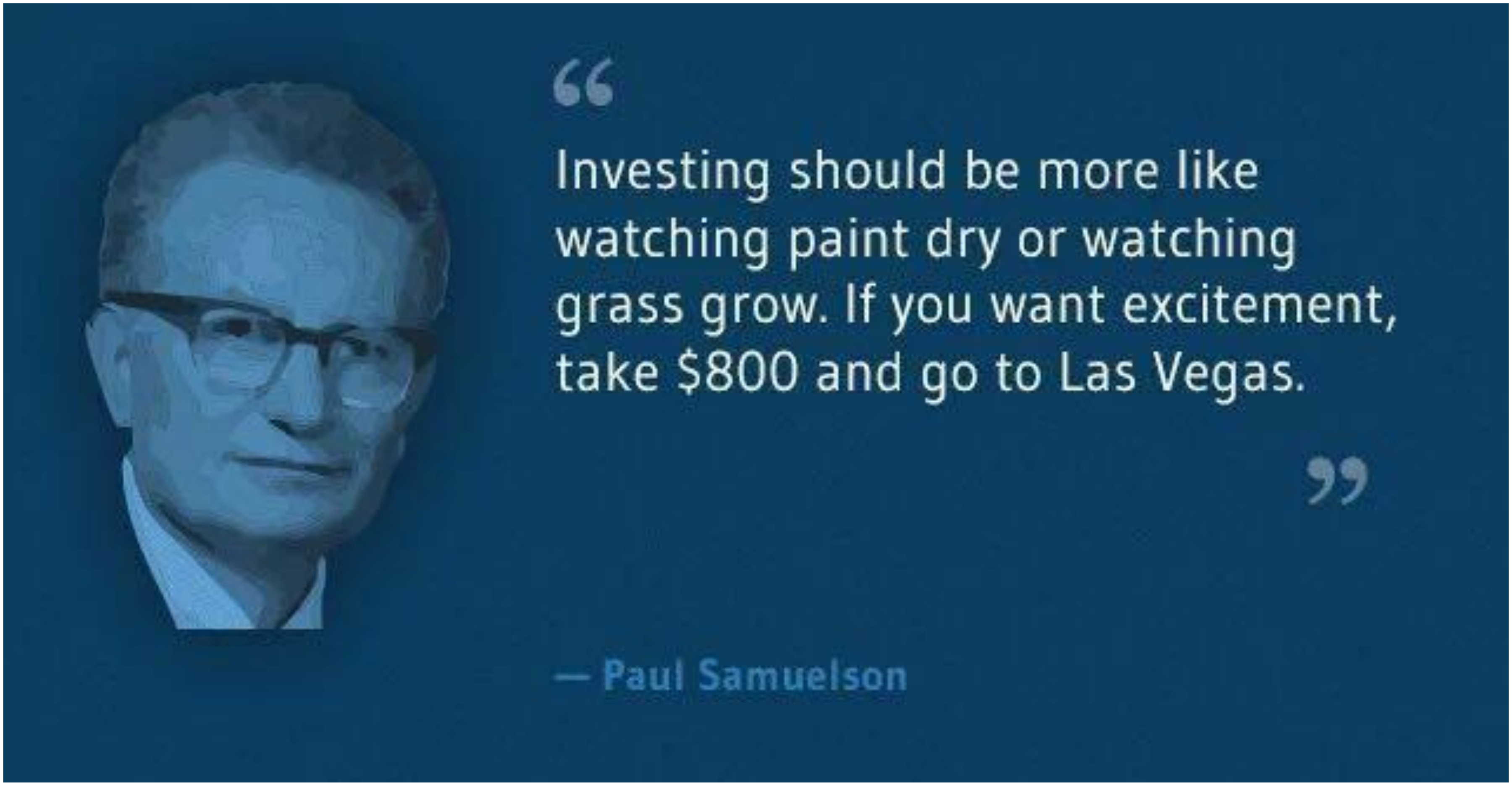
Wajir Paradise Hotel, Wajir County

On Investing… in anything



Part 1:
Classification & Measurement

Why is This Important?

* FVTPL – Fair value through profit or loss
  FVOCI – Fair value through other comprehensive income

- Although the permissible measurement bases for financial assets – amortised cost, FVOCI* and FVTPL* – are similar to IAS 39, the criteria for classification are significantly different and judgement will be needed.

- Evaluating contractual terms of financial assets and determining business models is likely to be a substantial project for most in financial sector.

- Impact on financial ratios, regulatory capital and other ratios, new product approval process and business strategy.

Learning outcomes

1. Describe the criteria for classification of financial instruments.
2. Describe measurement bases for financial instruments.
3. Describe, at a high level, the impact of classification and measurement requirements for companies in financial sector.

Classification and Measurement

- **Principal Changes From IAS 39**
- Classification of Financial Assets
- Measurement of Financial Assets
- Financial Liabilities Designated at FVTPL
- Reclassifications
- Effective Date and Transition
- Key Points to Remember

Financial Asset

Measurement categories

- Similar categories:

IFRS 9	IAS 39
FVTPL	FVTPL
Amortised cost	Loans and receivables/HTM*
FVOCI	AFS*

Significant changes in criteria for classifying assets.

* HTM – Held to maturity
  AFS – Available for sale

Financial Liability

Measurement

- Requirements from IAS 39 largely retained.
  - Classified as measured at amortised cost or FVTPL.
- Presentation in OCI* of gain or loss on a financial liability designated at FVTPL attributable to changes in own credit risk.

* OCI – other comprehensive income

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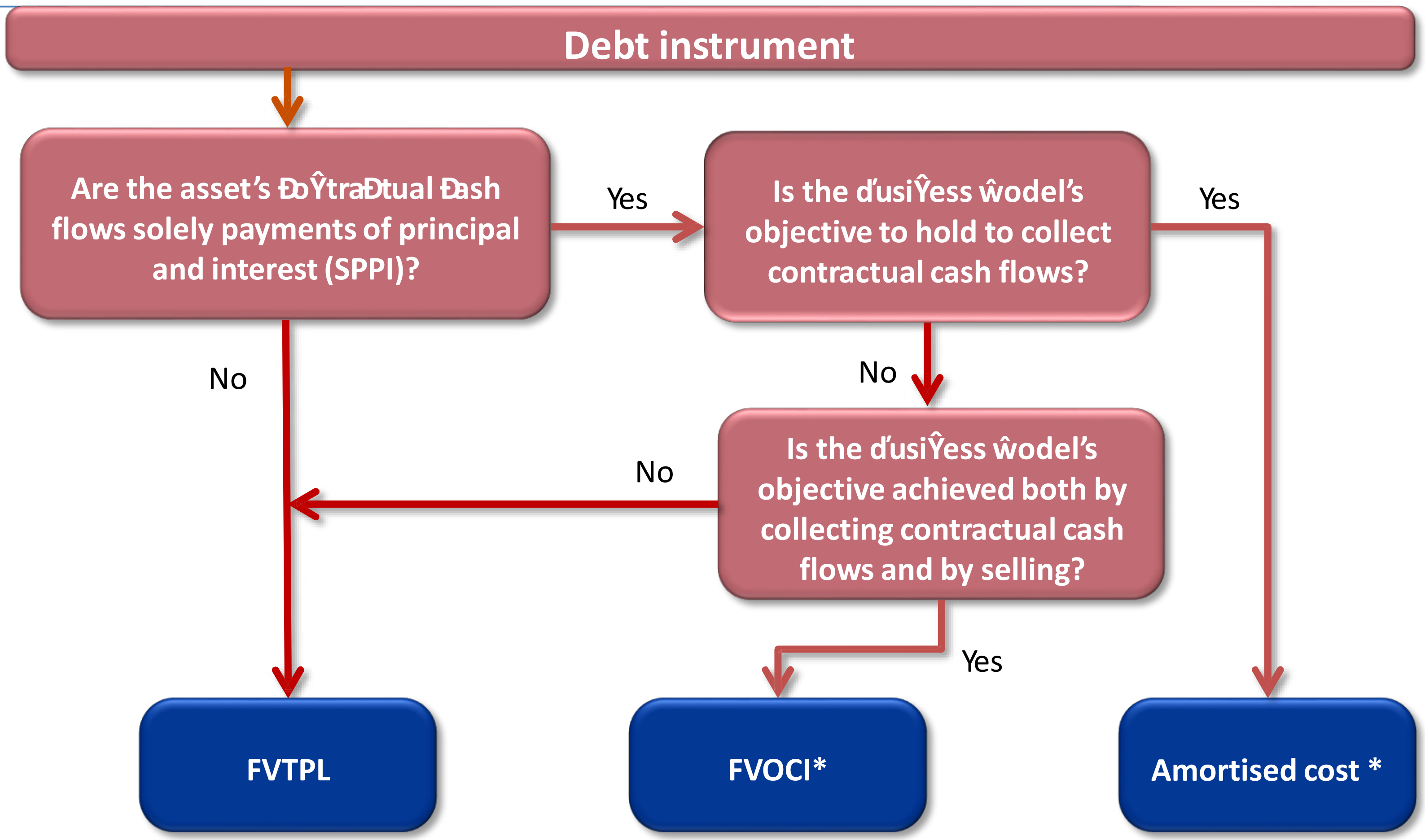
Classification of Financial Assets – Debt Instruments



* Subject to FVTPL designation option - if it reduces accounting mismatch

Business Model Assessment

- Business model assessment

- Business model refers to how an entity manages its financial assets in order to generate cash flows.
- Business model is a matter of fact – typically observable through the activities undertaken.
- Does not depend on management's intention for an individual instrument.
- However, judgement is often needed.

Types of Business Models

Held-to-collect contractual cash flows
▪ Financial assets held to collect contractual cash flows over the life of the instrument.
▪ Need not hold all instruments until maturity.
▪ Selling assets is incidental to business model objective.

Held both to collect contractual cash flows and to sell
▪ Both collecting contractual cash flows and selling financial assets are integral to achieving objective of business model.
▪ Typically involves greater frequency and value of sales compared to held to collect model.

Other business models
▪ Models that do not meet the above criteria.

Business Model Assessment: Considerations

In assessing business models, consider:

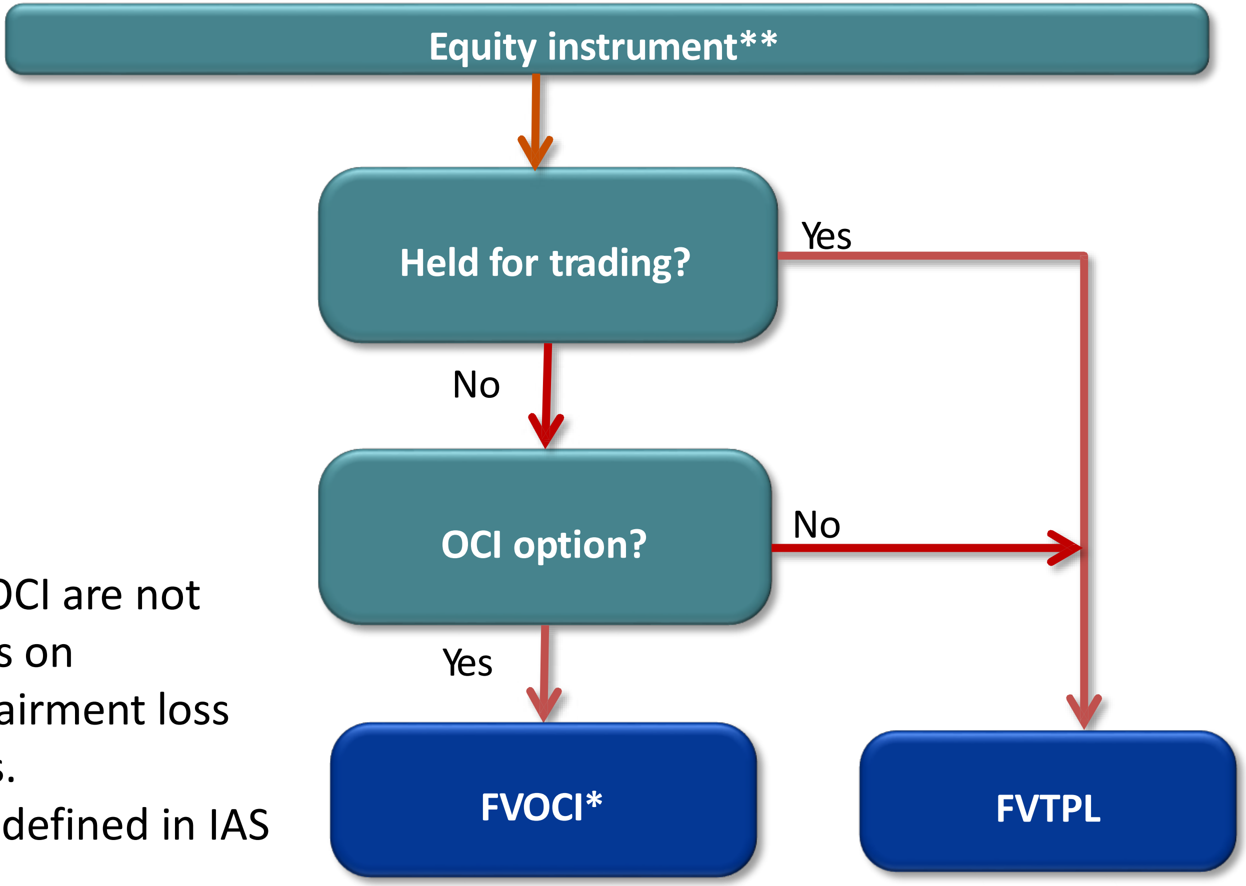
- How performance is evaluated and reported to key management personnel
- How managers are compensated
- The level that financial assets are managed, e.g. portfolio
- Risks affecting performance and how they are managed
- Actual and expected frequency, value and timing of sales

Examples of Business Models

ICPAK
Uphold Public Interest

- Liquidity portfolio to meet funding needs in stress conditions
- Liquidity portfolio to meet everyday funding needs
- Retails loans held for securitisation
- Fund assets managed on a fair value basis
- Trading instruments
- Financial assets to fund insurance liabilities
- Retail loans held to collect contractual cash flows

Classification of equity instruments



* Amounts recognised in OCI are not reclassified to profit or loss on derecognition and no impairment loss recognised in profit or loss.

** Equity instrument is as defined in IAS 32

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Measurement of Financial Assets

Measurement category	P&L	OCI	Presentation of gains/losses same as under IAS 39?
Amortised cost	All gains and losses	-	✓
Debt investments at FVOCI	Interest, impairment losses, foreign exchange gains and losses, gain or loss on disposal	Other gains and losses	✓
Equity investments at FVOCI	Dividends (unless clearly represents recovery of part of cost of investment)	Fair value gains and losses	✗
FVTPL	All gains and losses	-	✓

Measurement of Financial Assets: Equity Investments

- Equity investments at FVOCI:
  - On derecognition, amounts recognised in OCI are not reclassified to profit or loss (different to debt investments at FVOCI).
  - No impairment loss recognised in profit or loss.

- No cost exemption for equity investments and derivatives linked to such investments.

Measurement of Financial Assets: Amortised Cost

- When contractual cash flows are renegotiated or otherwise modified but do not result in derecognition:
  - Recalculate gross carrying amount (GCA)* of the financial asset and recognise a modification gain or loss in profit or loss.
  - Costs or fees incurred adjust carrying amount of modified financial asset and are amortised over remaining term.

*GCA = PV of renegotiated or modified contractual cash flows discounted at original EIR.

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- Audit Considerations and Resources
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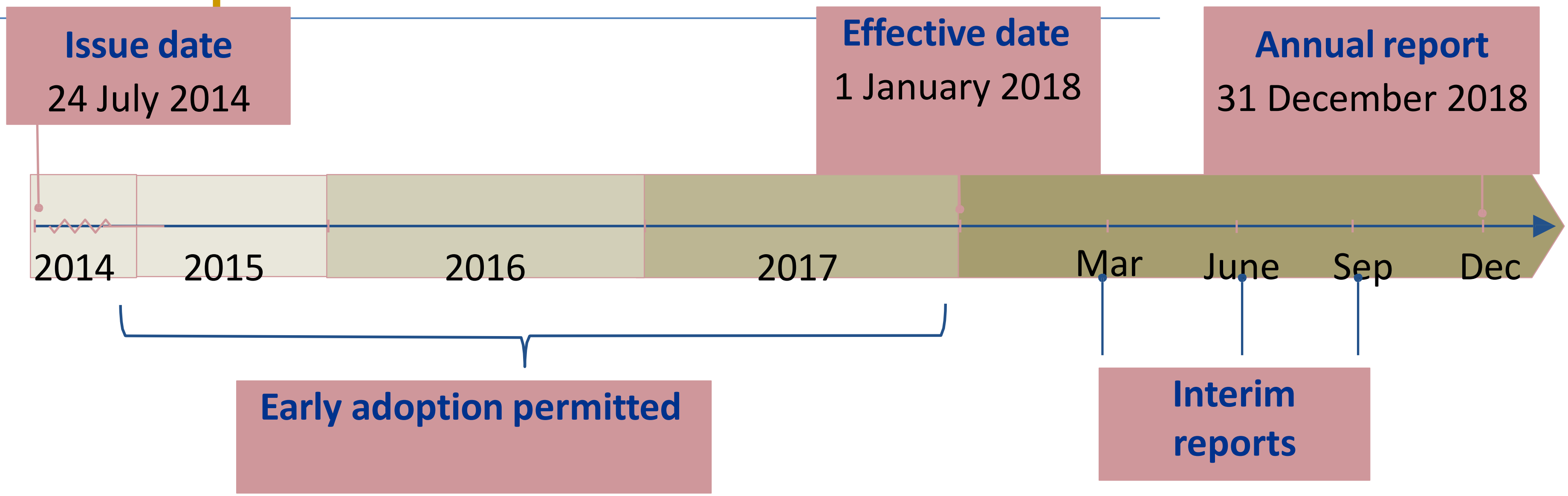
Effective Date and Early Adoption



- If date of initial application (DIA) is before 1 February 2015, entities may elect to apply earlier versions of IFRS 9.
  - "DIA" = date when entity first applies IFRS 9 requirements and must be beginning of a reporting period after 24 July 2014.
- Permitted to early adopt own 'credit requirements' in isolation.
- Early adoption may require permission by local regulators e.g. EU endorsement.

Transition for Classification and Measurement

Retrospective application, with some exemptions

Comparatives need not be restated (can be restated if possible without using hindsight)

Limited reopening of the FV option

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Key Considerations

Significant judgements

- Apply professional scepticism and judgement in auditing business model and SPPI assessments.

Changes in volatility in profit or loss and equity

- Evaluate client’s assessment of the impact, including covenants, financial ratios.
- Assess impact on determination of materiality levels.

Regulatory capital

- Evaluate impact on sufficiency of regulatory capital.

Extra resources for transition

- Preparedness for IFRS 9.
- Update understanding of accounting systems and processes.
- Assess impact on the effectiveness of internal controls.

Part II:
Impairment

Learning outcomes

1. Describe the new impairment model for financial instruments.
2. Describe the factors to consider in assessing a significant increase in credit risk.
3. Describe the factors to consider in measuring expected credit losses.
4. Describe, at a high level, the impact of impairment requirements for companies in the financial sector.

Impairment

- **Principal Changes From IAS 39**
- Scope of Impairment Model
- Impairment: Dual Measurement Approach
- Assessment of Significant Increases in Credit Risk
- Measurement of Expected Credit Losses
- Debt Financial Assets at FVOCI
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Principal Changes From IAS 39

	IAS 39	IFRS 9
Type of model	Incurred loss	Expected loss
Number of models	Several	One
Scope	Extended	
Equity investments	Impairment recognised for AFS* equity investments	No impairment recognised for equity investments
Judgement	Increased	

* AFS – Available for sale

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Scope of Impairment Model

In scope
▪ Debt instruments measured at amortised cost or at FVOCI*.
▪ Loan commitments issued not measured at FVTPL*.
▪ Financial guarantee contracts issued in the scope of IFRS 9 not measured at FVTPL.
▪ Lease receivables in the scope of IAS 17.
▪ Contract assets in the scope of IFRS 15.
Out of scope
▪ Equity investments.
▪ Financial instruments measured at FVTPL.

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Expected loss model – 3 stages

Change in credit quality since initial recognition

	Stage 1	Stage 2	Stage 3
Recognition of expected credit losses	12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Interest revenue	Effective interest on gross carrying amount	Effective interest on gross carrying amount	Effective interest on amortised cost carrying amount (that is, net of credit allowance)
	Performing (Initial recognition*)	*Underperforming* (Assets with significant increase in credit risk since initial recognition*)	*Non-performing* (Credit-impaired assets)

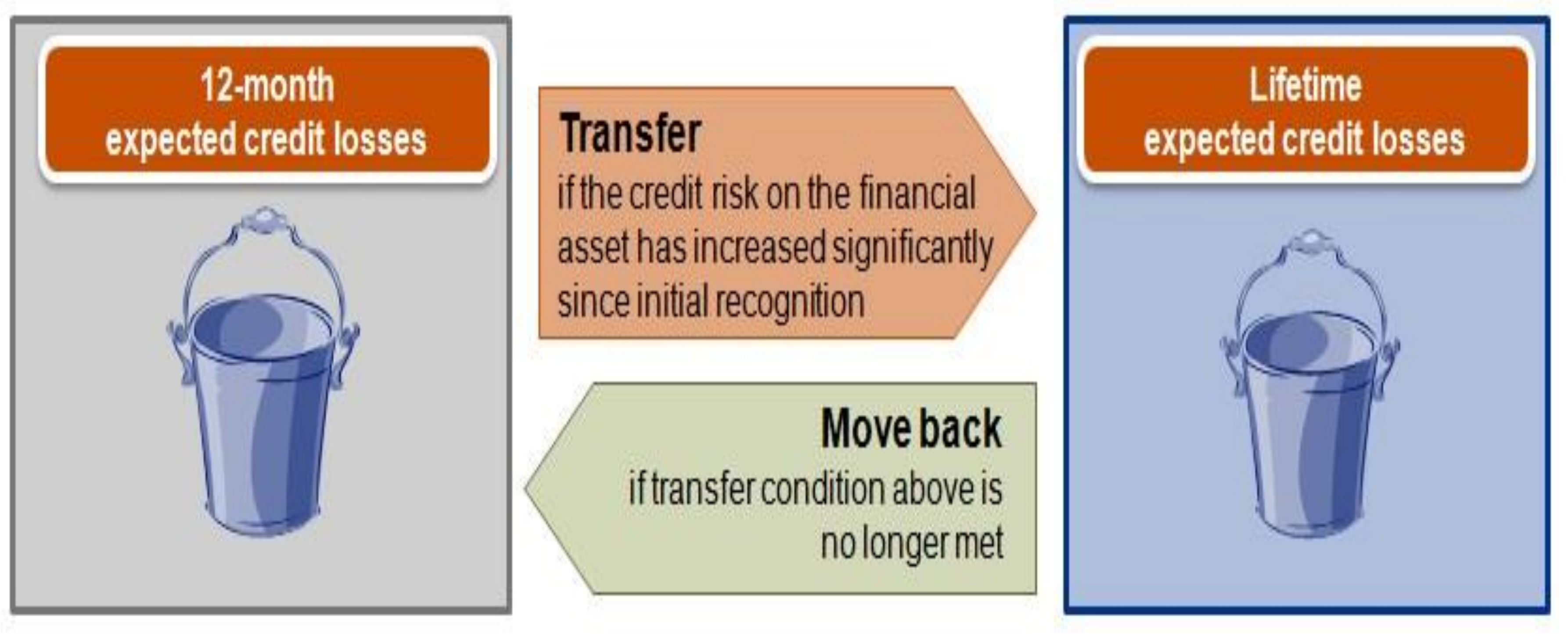
Dual Measurement Approach

- Under the general principle, one of two measurement bases applies:

✓ 12-month expected credit losses; or

✓ Lifetime expected credit losses.

- The measurement basis depends on whether there has been a significant increase in credit risk since initial recognition.



Dual Measurement Approach – Key Concepts

12-month expected credit losses	▪ Losses resulting from default events possible within 12 months after reporting date.
Lifetime expected credit losses	▪ Losses resulting from all possible default events over expected life of financial instrument.
Significant increase in credit risk	▪ Not defined.
Default	▪ Not defined.

Dual Measurement Approach – Applying a Definition of Default

- Consistent with definition used for internal credit risk management purposes for the relevant instrument.
- Consider qualitative indicators when appropriate, e.g. breach of covenants.
- May be the same as used for regulatory purposes but has to be consistent with the above two requirements.
- Should be applied consistently.

Rebuttable presumption that default does not occur later than 90 days past due

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Assessment of Significant Increases in Credit Risk – A Relative Concept

- Assessment based on change in risk of default since initial recognition.
- Not based on change in amount of ECL.
- Based on all reasonable and supportable information, including forward-looking info, available without undue cost or effort such as:

✓ Actual/expected internal/external credit rating changes.

✓ Actual/forecast macroeconomic data.

✓ Changes in price and market indicators of credit risk.

✓ Actual/expected changes in operating results/environment of borrower.

Assessment of Significant Increases in Credit Risk – A Relative Concept

- Cannot simply compare change in absolute risk of default.

–Risk of default tends to reduce over time.

–If risk of default has not reduced over time, this may indicate an increase in the credit risk.

–However, this may not be the case if significant payment obligations only close to maturity.

- Change in 12-month risk of default may be reasonable proxy.

Low Credit Risk Exception

1. The financial instrument has a low risk of default.

   Low risk of default

2. The borrower has a strong capacity to meet contractual cash flow obligations in the near term.

   Strong capacity to meet obligations in near term

3. Adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce ability of the borrower to fulfil its contractual cash flow obligations.

   Adverse changes will not necessarily reduce ability to fulfil obligations

Low Credit Risk Exception

- If low credit risk - may assume credit risk has not increased significantly since initial recognition.
- Instrument-by-instrument decision.
- External rating of an ‘investment grade’ is an example of an instrument that may be considered to have low credit risk.
  – May use internal or external credit risk ratings.
- If instrument no longer is low risk, no automatic assumption that risk has increased significantly.
- Key impact: externally rated bonds.

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Measurement of Expected Credit Losses

Expected credit losses on financial assets

Probability weighted

Unbiased probability-weighted amount (evaluate range of possible outcomes and consider risk of credit loss even if probability is very low)

Present value

Generally calculated using original EIR or an approximation as discount rate

Cash shortfalls

Difference between cash flows due under the contract and cash flows that entity expects to receive

What is the Estimation Period?

- Generally the maximum contractual period over which entity exposed to credit risk:
  - E.g. loan commitments - maximum contractual period entity has present contractual obligation to extend credit.
- Exception for certain financial instruments that:
  - Include both loan and undrawn commitment component.
  - Can be contractually withdrawn with little notice.
  - Ability to cancel does not limit the lender’s exposure
- Measure expected credit losses over the period entity is exposed to credit risk.

Expected credit losses

Bucket 1	Bucket 2	Bucket 3
12-month ECL = the expected credit losses that result from default events that are possible within 12 months after the reporting date.	Lifetime ECL are recognized. Interest revenue is calculated on Gross Carrying Amount of the asset.	Lifetime ECL are recognized and interest revenue is calculated on the net carrying amount.
It is not the expected cash shortfalls over the 12-month period but the entire credit loss on an asset weighted by the probability that the loss will occur in the next 12 months.	Expected credit losses are the weighted average credit losses with the probability of default ('PD') as the weight.	Net carrying amount = GCA net of credit allowance.

Expected credit losses

- The ECL model relies on a relative assessment of credit risk. This means that a loan with the same characteristics could be included in Stage 1 for one entity and in Stage 2 for another, depending on the credit risk at initial recognition of the loan for each entity.
- Moreover, an entity could have different loans with the same counterparty that are included in different stages of the model, depending on the credit risk that each loan had at origination.

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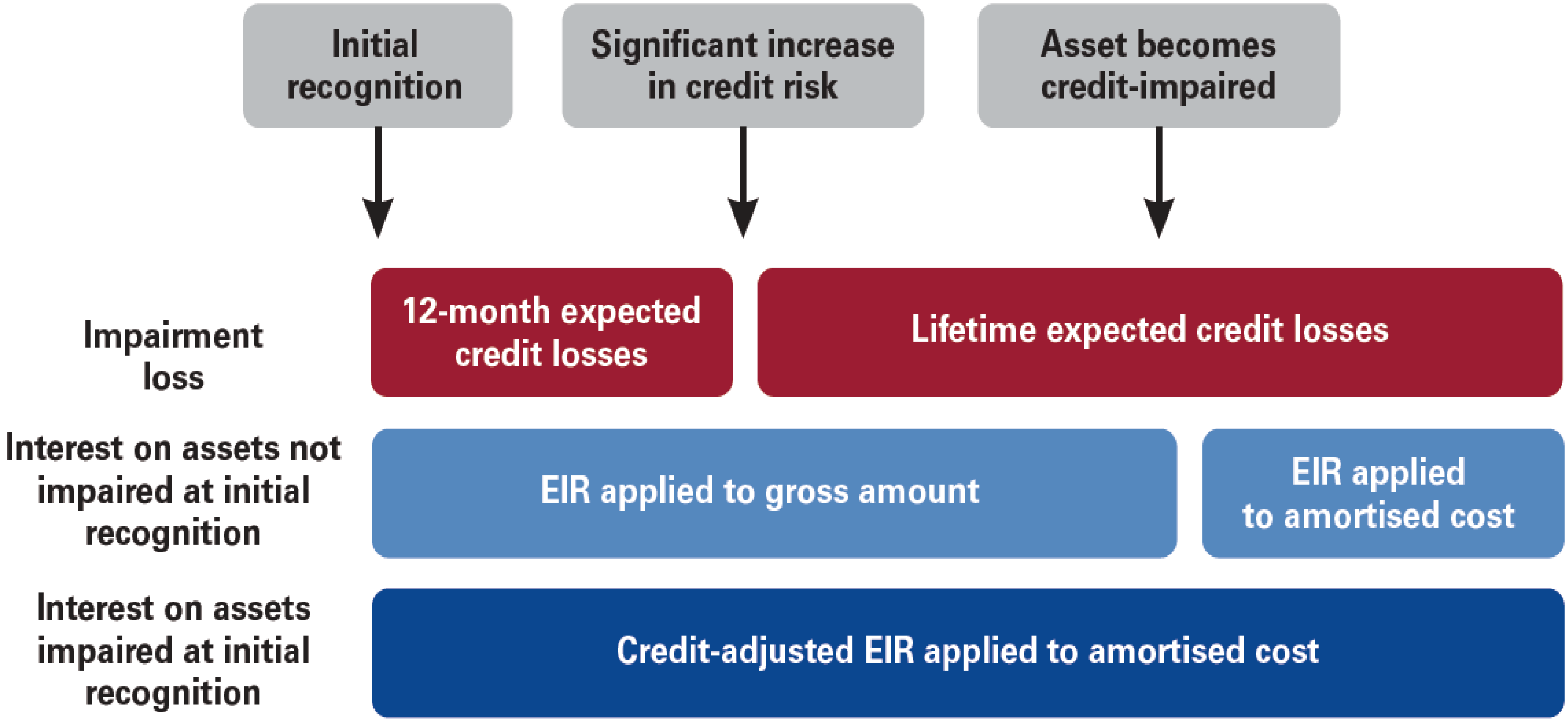
Interest Recognition



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Disclosures

Quantitative disclosures	Qualitative disclosures
Reconciliation of opening to closing amounts of loss allowances showing key drivers of change	Inputs, assumptions and estimation techniques for estimating ECL
Reconciliation of opening to closing amounts of GCAs showing key drivers of change	Inputs, assumptions and estimation techniques to determine significant increases in credit risk and default
GCAs by credit risk grade	Inputs, assumptions and techniques to determine credit-impaired assets
Write offs, recoveries and modifications	Wrote off policies, modification policies and collateral

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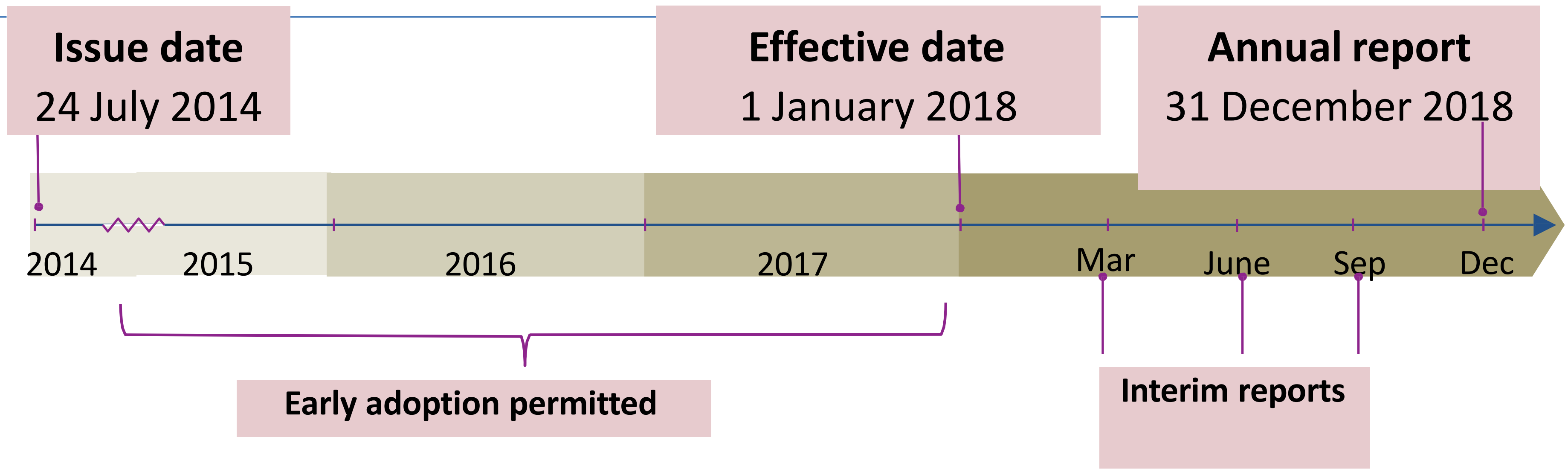

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  - "DIA" = date when entity first applies IFRS 9 requirements must be beginning of a reporting period after 24 July 2014.
- Early adoption may require permission by local regulators e.g. EU endorsement.

New standards

New IFRS 2017-2019

Standard/amendment/ interpretation	Effective date	Adoption status
1 January 2017		
Amendment to IAS 12, 'Income taxes', regarding recognition of deferred tax assets for unrealised losses'	Annual periods beginning on or after 1 January 2017	Early adoption is permitted
Amendment to IAS 7, 'Cash flow statements', regarding the Disclosure initiative	Annual periods beginning on or after 1 January 2017	Early adoption is permitted
Annual improvements 2014-2016 IFRS 12, 'Disclosure of interests in other entities'	Annual periods beginning on or after 1 January 2017	Early adoption is permitted

New IFRS 2017-2019

1 January 2018		
IFRS 9, 'Financial instruments'	Annual periods beginning on or after 1 January 2018	Early adoption is permitted
IFRS 15, 'Revenue from contracts with customers'	Annual periods beginning on or after 1 January 2018	Early adoption is permitted
Amendment to IFRS 15, 'Revenue from contracts with customers' Clarifications	Annual periods beginning on or after 1 January 2018	Early adoption is permitted
Amendments to IFRS 2, 'Share based payments' classification and measurement of share-based payment transactions	Annual periods beginning on or after 1 January 2018	Early adoption is permitted

New IFRS 2017-2019

Amendments to IFRS 4, 'Insurance contracts', regarding implementation of IFRS 9	Annual periods beginning on or after 1 January 2018	Early adoption is permitted
Amendment to IAS 40, 'Investment property' regarding the transfer of property	Annual periods beginning on or after 1 January 2018	Early adoption is permitted
Annual improvements 2014-2016 IFRS 1, 'First time adoption of IFRS', regarding IFRS 7, IAS 19 and IFRS 10, IAS 28 'Investment in associates and joint ventures'	Annual periods beginning on or after 1 January 2018	Early adoption is permitted
IFRIC 22, 'Foreign currency transactions and advance consideration'	Annual periods beginning on or after 1 January 2018	Early adoption is permitted

New IFRS 2017-2019

1 January 2019		
IFRS 16, 'Leases'	Annual periods beginning on or after 1 January 2019	Early adoption is permitted if IFRS 15 is also adopted

IFRS 17

Overview of IFRS 17

IFRS 17 deals with Insurance Contracts

The effective date is 1st January 2021

Preparations underway to ensure smooth transition from IFRS 4 which is an interim standards.

ICPAK will guide on the implementation in conjunction with other stakeholders.

Rapidly changing reporting environment

Implication for Business and Taxation

Harmonisation of markets

Increasing complexity

Detailed disclosures

Use of fair values

Increasing principles based

Stakeholder activism

Financial innovation

Questions & comments