THE FINANCIAL REPORTING FOR COUNTY GOVERNMENTS AND OTHER PUBLIC SECTOR ENTITIES CONFERENCE

Date: 8th – 12th March 2021

Venue: Pride Inn Beach Resort and Spa – Mombasa

Day 3, Session I : IPSAS 19, IPSAS 39 and IPSAS 41

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Content

1. IPSAS 19 - Provisions, Contingent Liabilities and Contingent Assets
2. IPSAS 39- Employee Benefits
3. IPSAS 41- Financial Instruments

1.1. IPSAS 19

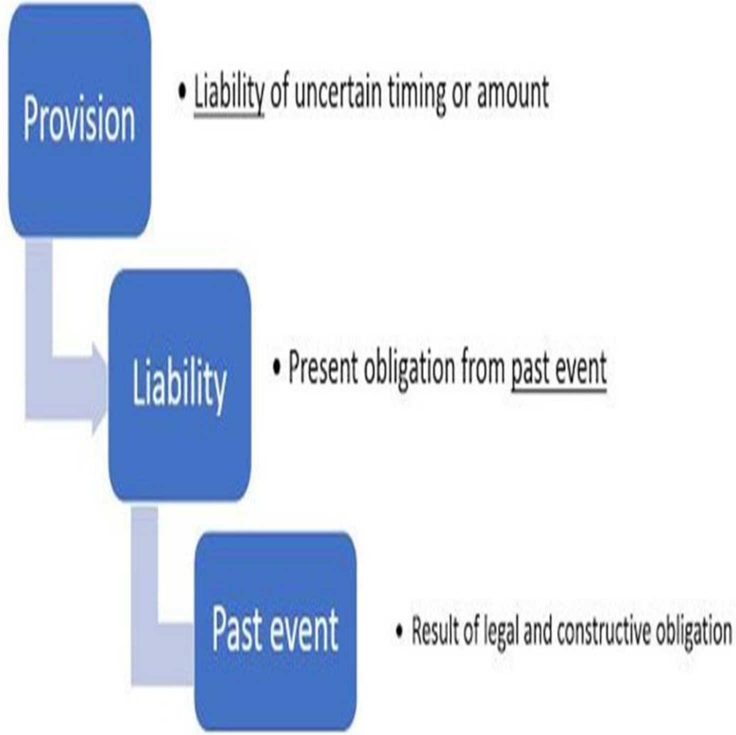
IPSAS 19 Prescribes clear-cut rules and guidance in respect of the recognition and measurement of provisions, contingent liabilities, and contingent assets. It also makes certain disclosures mandatory for the companies.

One objective is to make it difficult for an entity to manipulate the financial reports with the help of provisions i.e. high provisions with good performance good, but low provisions with poor performance.

1.2. Provisions

Definition

A provision is a liability of uncertain timing or amount. Remember a liability is a present obligation of the entity to transfer an economic resource as a result of past events. An obligation is a duty or responsibility that the entity has no practical ability to avoid (The Framework)



1.2. Provisions

Definition

Provisions can be distinguished from other liabilities such as trade payables and accruals because, for provisions there is uncertainty about the *timing* or *amount* of the future expenditure required in settlement. By contrast, trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier.

1.2. Provisions

Definition

Accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid for, invoiced or formally agreed with the supplier. Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions. Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

1.2. Provisions

2.1. Provisions - Recognition

A provision shall only be recognized when:

(a) An entity has a **present obligation** (legal or constructive) as a result of a past event; for example, there is a court case (legal) or the firm has made promises that can be enforced (constructive).

(b) It is probable that an **outflow of resources** embodying economic benefits (service potential under IPSAS 19) will be required to settle the obligation i.e. more than 50% chance that a payment would be made (based on expert advice or past experience).

1.2.1. Provisions - Recognition

(c) A **reliable estimate** can be made of the amount of the obligation. Provisions are measured at the best estimate of the expenditure required to settle the present obligation at reporting date. Where the provision being measured involves a large population of items (i.e. goods' warranties), the obligation is estimated by weighting all possible outcomes by their associated probabilities.

1.2.1. Provisions - Examples

No	Example	Present Obligation?	Probability of Outflow of Resources	A reliable Estimate of Amount?	Is it Provision ?
1	Future Operating Losses				
2	Onerus Contract				
3	Restructuring Costs				
4	Warranties				
5	Contaminated Land				
6	Refunds Policy				
7	A court Case				

2.1. Provisions – Recognition: Examples

1. Future operating losses

Provisions shall not be recognized for future operating losses/deficits. Future operating losses/deficits do not meet the definition of a liability and the general recognition criteria set out for provisions. There is no past event and even though there maybe some probability of making losses given company/entity and market conditions, it may not be possible to come up with a reasonable estimate of the amount.

1.2.1. Provisions – Recognition: Examples

2. Onerous contract

Is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. If an entity has a contract that is onerous, the present obligation under the contract shall be recognized and measured as a provision. For onerous contract, the provision is recognized and measured at the lower of:

-The cost of fulfilling the contract

-The costs/penalties incurred in cancelling the contract.

1.2.1. Provisions – Recognition: Examples

3. Restructuring costs

A restructuring is a programme that is planned and controlled by management, and materially changes either the scope of an entity undertaken by an entity or the manner in which operations are conducted.

Examples of events that may fall under the definition of restructuring:

(a) Sale or termination of a line of the organization,

2.1. Provisions – Recognition: Examples

3. Restructuring costs

(b) The closure of locations in a country or region or the relocation of activities from one country or region to another.

(c) Changes in management structure, for example, eliminating a layer of management and

(d) Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations.

1.2.1. Provisions – Recognition: Examples

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3. Restructuring costs

A provision for restructuring should only be made when an entity has a detailed formal plan for the restructuring and the entity has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

1.2.1. Provisions – Recognition: Examples

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4. Warranties

A dealer gives warranties at the time of sale to purchasers of its product where the terms of the contract require the dealer to make good, by repair or replacement defects that become apparent within a given period from the date of sale. A provision is recognized for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period.

1.2.1. Provisions – Recognition: Examples

5. Contaminated Land

An entity in the oil industry causes contamination and operates in a country where there is either environmental legislation or has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. A provision is recognized for the best estimate of the costs of clean-up.

1.2.1. Provisions – Recognition: Examples

6. Refunds Policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known. A provision is recognized for the best estimate of the costs of refunds.

1.2.1. Provisions – Recognition: Examples

7. A court Case

A firm is being sued by a former employee for wrongful termination. The former employee is seeking damages from the entity but the entity disputes liability. Up to the date of authorization of the financial statements for issue, the entity's lawyers advise that it is probable (more than 50% chance) that the entity will not be found liable. No provision is recognized. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote in which it need not be disclosed.

1.3. Contingent Liabilities

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A contingent liability is:

(i) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or,

(ii) A present obligation that arises from past events but is not recognized because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured with sufficient reliability.

1.3. Contingent Liabilities

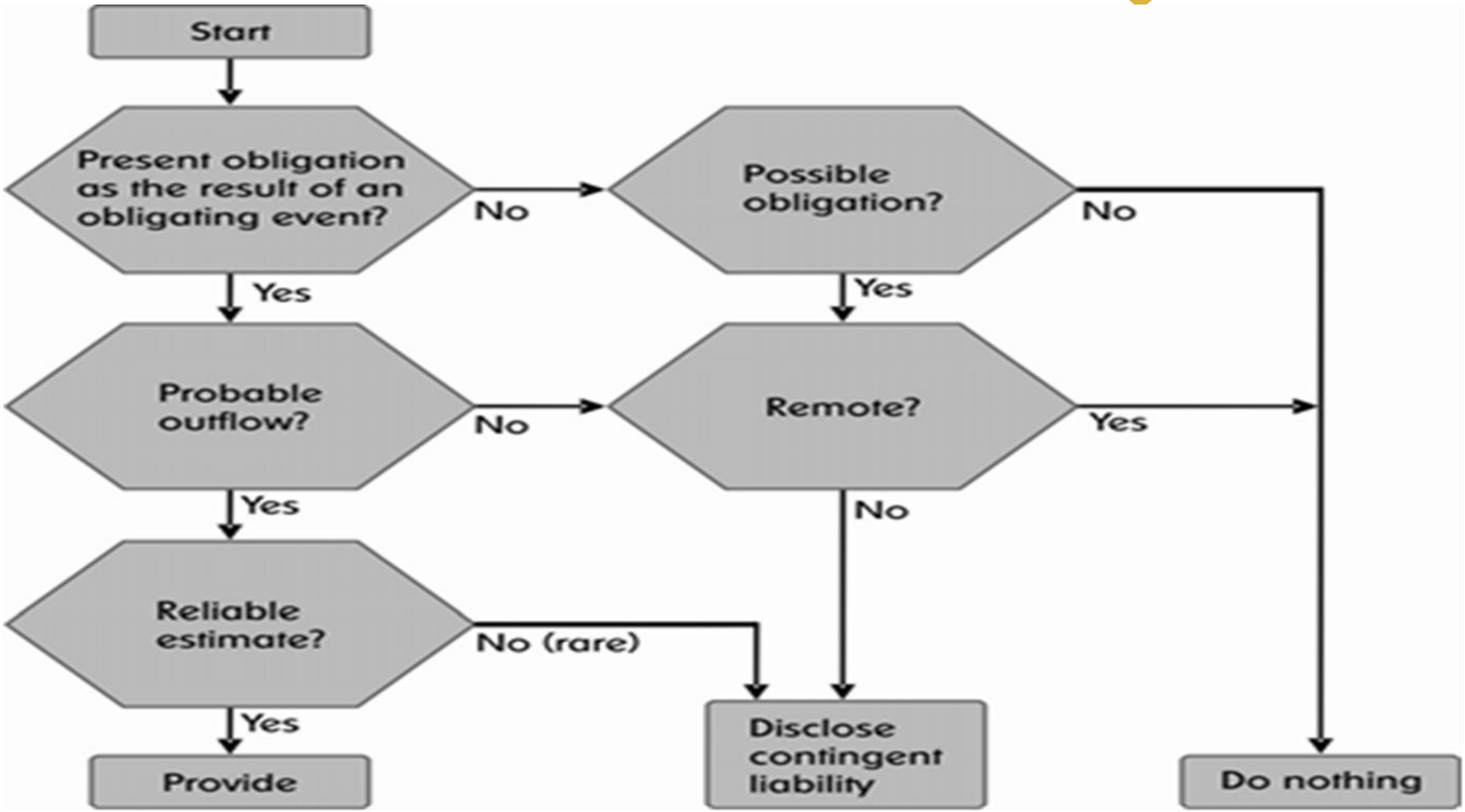
In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, under IAS 37 term ‘contingent’ is used for liabilities and assets that are not recognized because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

1.3. Contingent Liabilities

In addition, the term ‘contingent liability’ is used for liabilities that do not meet the recognition criteria. Remember Provisions are due to past events, while contingent liabilities are waiting for future events.

Therefore, an entity shall not recognize a contingent liability. A contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

1.3. Contingent Liabilities



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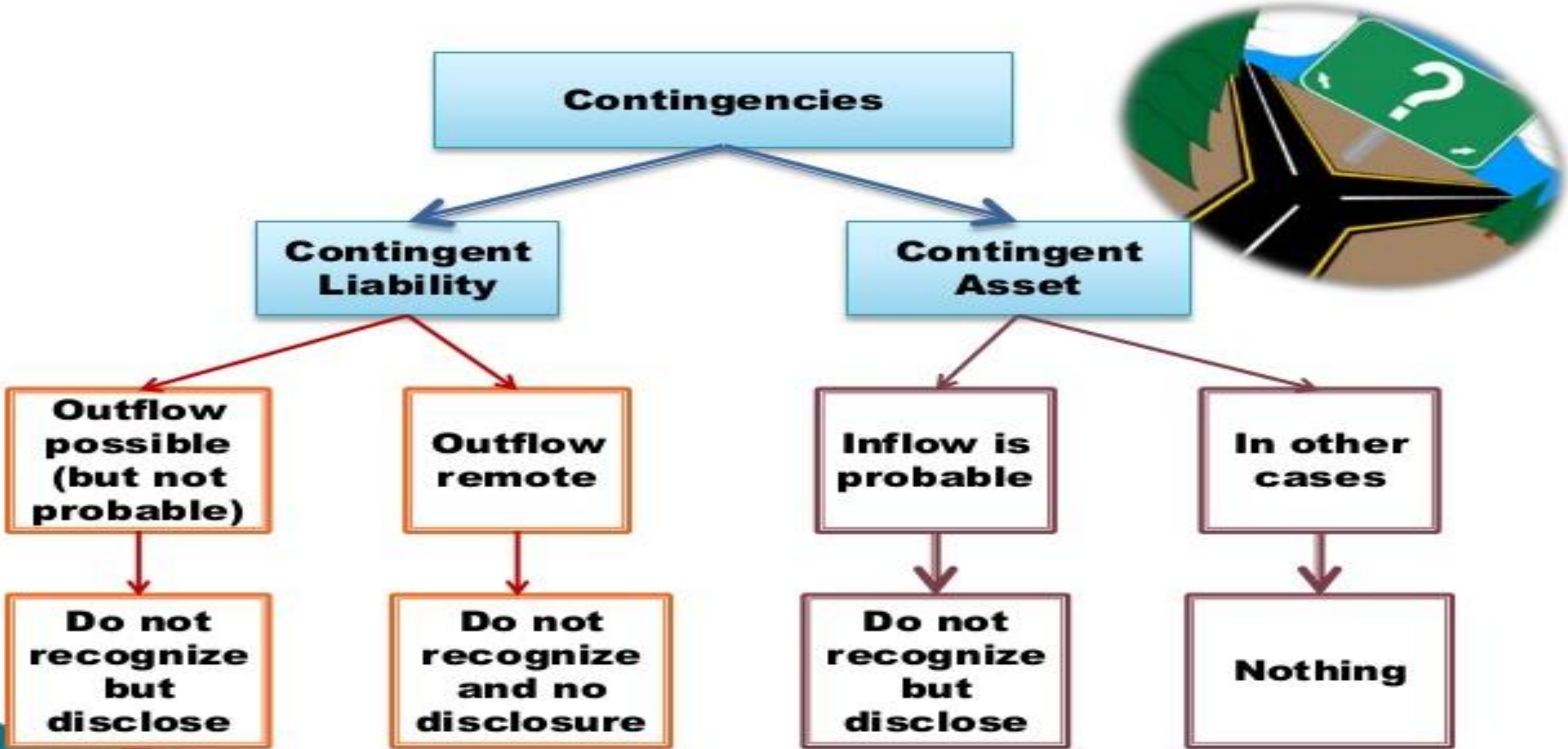
1.3. Contingent Assets

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

An entity shall not recognize a contingent asset. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity.

1.3. Contingent Assets



1.4. Disclosures

1. For each class of provision, the carrying amount at the beginning and end of the period; additional provisions made in the period, including increases to existing provisions; amounts used (ie incurred and charged against the provision); unused amounts reversed during the period; and the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

1.4. Disclosures

2. An entity shall disclose the following for each class of provision: a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits; an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events, he amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.

1.4. Disclosures

3. Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the end of the reporting

(a) period a brief description of the nature of the contingent liability and, where practicable: an estimate of its financial effect, measured under;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.

1.4. Disclosures

In extremely rare cases, disclosure of some or all of the information required can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

2. IPSAS 39 Employee Benefits

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees.

The main objective of IPSAS 39 is to provide guidance on the accounting treatment of employee benefits by Public sector entities. IPSAS 39 Short term employee benefits, Long Term Employee benefits, Termination benefits and Post Employment benefits.

2. IPSAS 39 Employee Benefits

The main principles in IPSAS 39 is that employee benefits should be expensed as employees provide services to the entity. Post employment benefits, which are provided when an employee retires are usually difficult to account for, so a major part of the standard focuses on the same.

2.1 Short term employee benefits

Short-term employee benefits are those expected to be settled wholly within the 12 months after the reporting period end, in which the employee has rendered the related services.

If the entity's expectations of the timing of settlement change temporarily, it need not reclassify a short-term employee benefit.

2.1 Short term employee benefits

All shortterm benefits should be recognized as an expense /liability at the undiscounted amount e.g. wages, salaries, bonuses, etc.

Compensated absences

- Accumulating–recognize expense when service that increases entitlement is rendered. e.g. leave pay.
- Non-accumulating–recognize expense when absence occurs.

2.2 Long-term employee benefits

Definition

Long term employee benefits are employee benefits (other than post-employment benefits and termination benefits) that are not due to be settled within twelve months after the end of the period in which the employees render the related service.

Main examples are profit sharing and bonus plans, long-term paid absences such as long-service or sabbatical leave, long-service benefits, long-term disability benefits and deferred remuneration.

2.2 Long-term employee benefits

Accounting Treatment

An entity should recognize an expense and a corresponding liability for the cost of providing profit-sharing arrangements and bonus payments when:

(i) The entity has a present legal or constructive obligation.

(ii) A reliable estimate of the obligation can be made.

2.2 Long-term employee benefits

Example

Costa, a state corporation, has a financial year end is 30 June. The company has a past practice of paying an annual bonus to employees, although it has no contractual obligation to do so. Its practice is to appropriate 4% of its pre-tax profits, before charging the bonus, to a bonus pool and pay it to those employees who remain in employment on the following 30 September.

2.2 Long-term employee benefits

Example

The total bonus is allocated to employees in proportion to their 30 June salaries, and amounts due to those leaving over the next three months are retrieved from the bonus pool for the benefit of the Company. Past experience shows that employees with salaries representing 8% of annual salaries leave employment by 30 September. The entity's pre-tax profits for the year ended 30 June 2020 were sh.40 million.

Required: Compute the amount to be expensed.

2.3 Termination benefits

Definition

Termination benefits are benefits to employees arising as a consequence of termination of their employment. An example is the payment of a lumpsum to an employee who volunteers for early retirement.

2.3 Termination benefits

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Accounting Treatment

IAS 19 requires that these costs should be recognized in full as a liability and an expense in the financial period when the entity recognizes a demonstrable obligation to pay those benefits at some time in future. Evidence of a demonstrable obligation would be a formal plan (e.g. a plan for voluntary redundancy) drawn up and communicated to the people affected.

2.4 Post Employment benefits

Definition

Post employment benefits are employee benefits (other than termination benefits) which are payable after the completion of employment. Main examples include:

-Retirement benefits (e.g. pensions, lump sum payments)

-Other post-employment benefits (e.g. post employment life insurance, medical care). Entities usually operate two types of pension plans for employment benefits.

2.4 Post Employment benefits

1. Defined Contribution Plan -Definition

A defined contribution plan is where an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employees benefits relating to employee service in the current and prior periods.

Usually, the contribution is a fixed amount per annum, and on retirement, the employee faces the risk of insufficient funds to cater for retirement.

2.4 Post Employment benefits

1. Defined Contribution Plan - Accounting

The entity should charge the agreed pension contribution to profit or loss as an employment expense in each period.

In case the organization has not paid the amount, it is accrued as a liability in the statement of financial position.

2.4 Post Employment benefits

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2. Defined Benefit Plan

All post-employment benefits plans other than defined contribution plans are considered defined benefit plans.

The contribution to the pension fund is not certain and varies from year to year. An actuary is usually appointed to calculate the amounts to be paid to the fund each year. The calculation is based on various estimates and assumptions including life expectancy, discount rate, investment returns, wage inflation, etc.

2.4 Post Employment benefits

2. Defined Benefit Plan

Because the employer promises an employee a certain benefit = "defines the benefit" on retirement, the employer bears the risk. The employer contributes to a fund to cater for the benefit. Therefore, IPSAS 39 requires the entity to recognize in the statement of financial position both an asset (The pension fund investments) and a pension liability (The defined benefit promised to employee, usually discounted to the present).

2.4 Post Employment benefits

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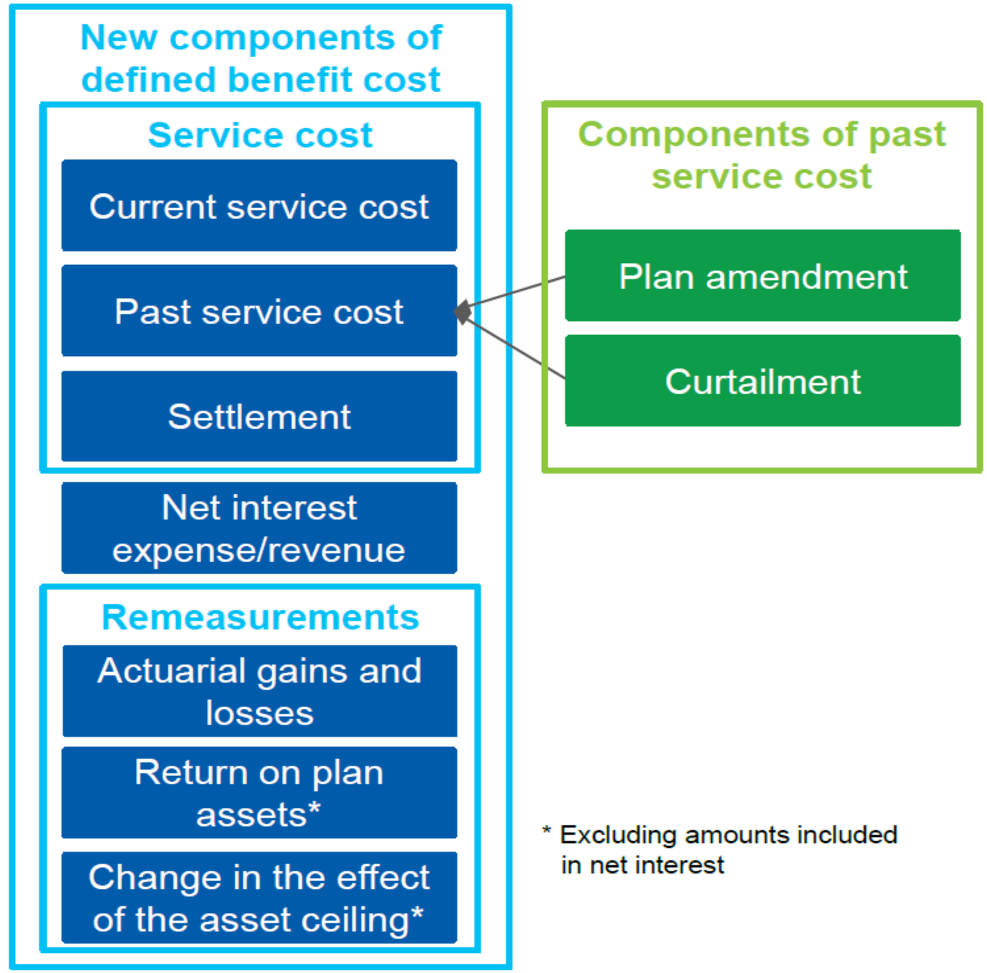
2. Defined Benefit Plan

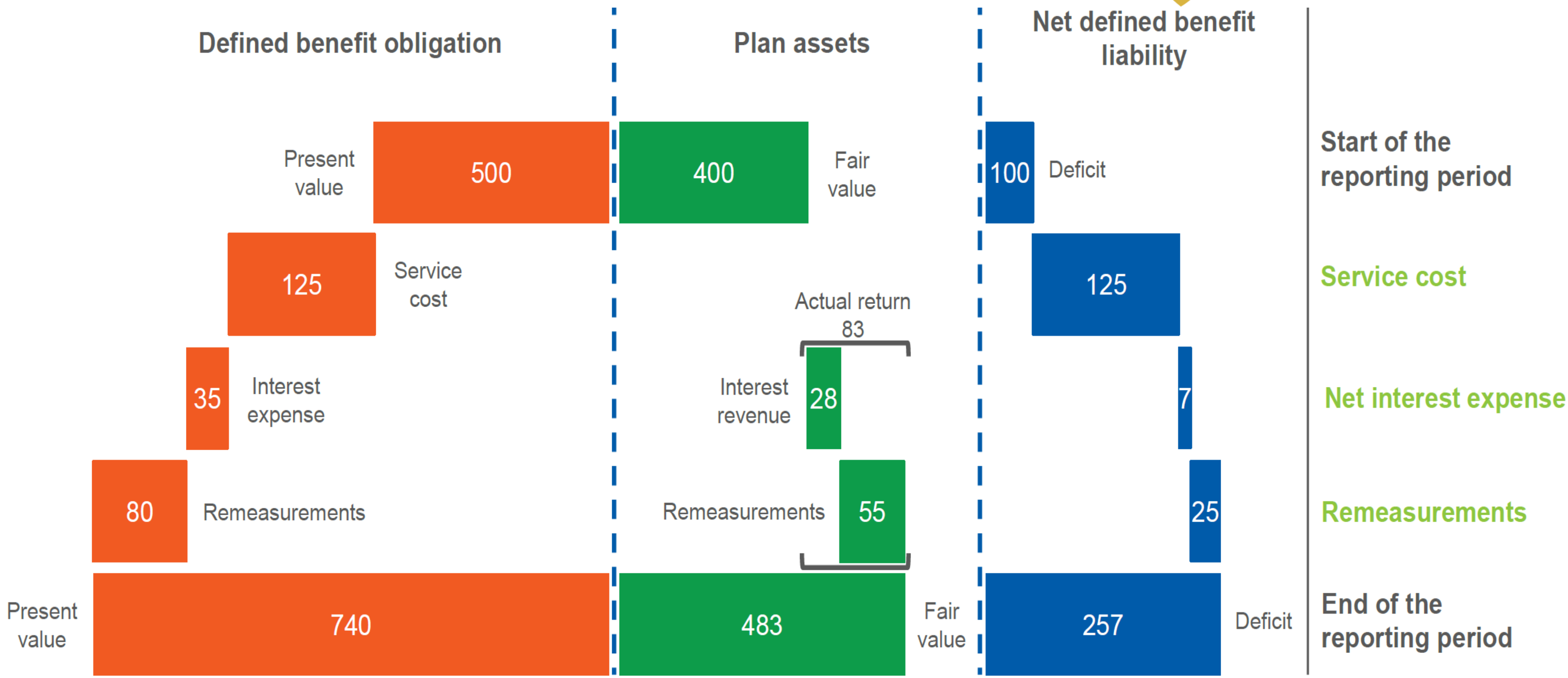
IPSAS 39 provides detailed guidelines on how to account for changes in the both the pension assets and pension liability. The next session provides a high-level summary of the key changes that take place in the assets and liabilities and how these are reflected in the statement of profit or loss, comprehensive incomes and the statement of financial position. The idea is to establish the make up of the net benefit cost and eventually the liability.

2.4 Post Employment benefits

- Service cost – the liability that arises from employees providing service during the period.
- Net interest – the interest expense/revenue on the net defined benefit liability (asset).
- Remeasurements – other changes in the value of the defined benefit obligation, such as changes in estimates and other changes in the value of plan assets.



2.4 Post Employment benefits



2.4 Other issues – Defined Benefits

Settlements

IPSAS 39 clarifies that a settlement is:

- The difference between the present value of the defined benefit obligation being settled and the settlement price; and
- A payment of benefits that is not set out in the terms of the plan.

As a consequence, any difference between an estimated benefit payment and the actual benefit payment is an actuarial gain or loss.

Taxes and administration costs

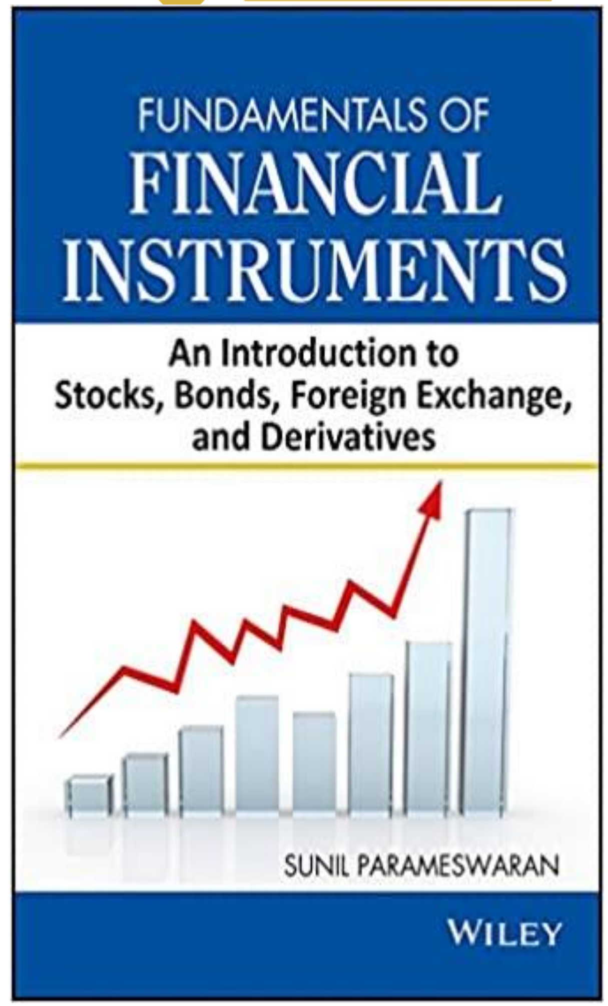
IPSAS 39 clarifies that:

- Taxes payable by the plan on contributions related to service before the reporting date, or on benefits resulting from that service are included in the estimate of the present value of the defined benefit obligation;
- Other taxes should be deducted from the return on plan assets; and
- Administration costs directly related to the management of plan assets are deducted from the return on plan assets.

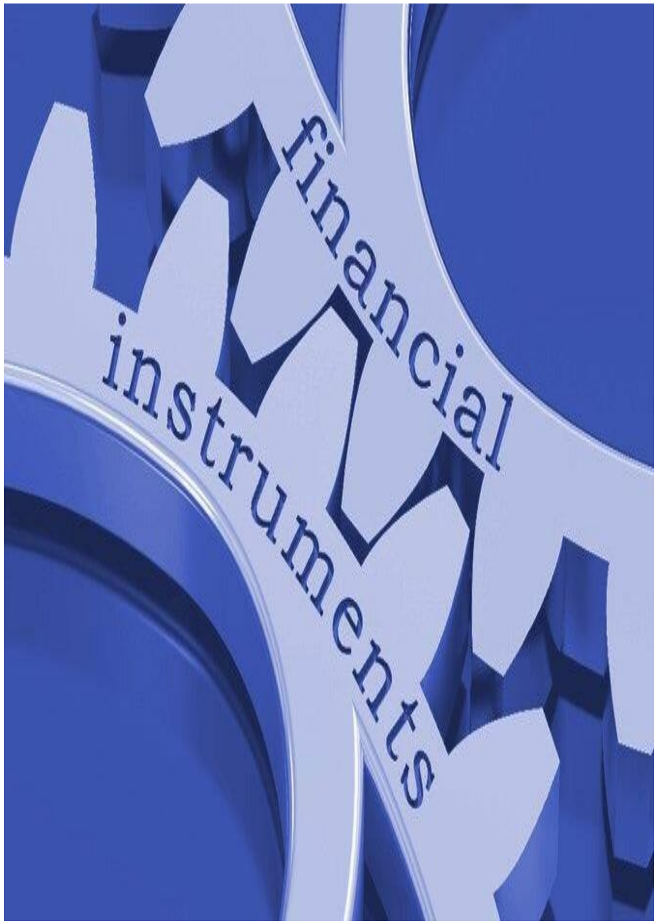
3. IPSAS 41 Financial Instruments

3.1 Introduction

Financial Instruments are simply a means of borrowing and lending. Their accounting treatment and presentation has been somewhat controversial, and IPSASB, guided by IASB has made substantial effort to improve consistency in their accounting treatment, presentation and disclosures, by lenders and borrowers.



3. IPSAS 41 Financial Instruments



3.1 Introduction

The main objective of IPSAS 41 is to establish new requirements for classifying, recognizing and measuring financial instruments to replace those in IPSAS 29, Financial Instruments: Recognition and Measurement.

IPSAS 41 is based on International Financial Reporting Standard (IFRS) 9, Financial Instruments, developed by the International Accounting Standards Board (IASB®).

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IFRS 9 provides accounting treatment of the following:

3. IPSAS 41 Financial Instruments

		Lenders	Borrowers
1	Definitions (IAS 32 and IFRS 9)	√	√
2	Recognition (IFRS 9, IAS 3 provides additional guidance on equity/ Financial liabilities by borrowers)	√	√
3	Classifications (IFRS 9)	√	√
4	Initial Measurement (IFRS 9)	√	√
5	Subsequent Measurement (IFRS 9)	√	√
6	Reclassifications (IFRS 9)	√	N/A
7	De-recognition (IFRS 9)	√	√
8	Impairment of Financial Assets (IFRS 9)	√	N/A
9	Hedging (IFRS 9)	√	√
10	Embedded Derivatives (IFRS 9)	√	√
11	Disclosures (IFRS 7)	√	√

3.1 Definitions

A **Financial Instrument** is any **contract** that gives rise to ▪ a **financial asset** of one entity; and ▪ a **financial liability or equity instrument** of another entity.
A Financial Asset is any asset that is: ▪ cash **e.g.** cash in hand or at bank ▪ an equity instrument of another entity **e.g.** investment in shares or share options. ▪ a contractual right to receive cash (or another financial asset) **e.g.** trade receivables, loans and Investments in bonds. ▪ a contractual right to exchange financial instruments under conditions that are potentially favorable **e.g.** Derivatives that have a positive payoff. ▪ a non-derivative contract for which the entity is or may be obliged to **receive** a variable number of the entity's own equity instruments **e.g.** a contract with customer to receive our own shares/options (variable number or fixed amount).

3.1 Definitions

A **Financial Liability** is any liability that is: ▪ a contractual obligation to deliver cash (or another financial asset) **e.g.** Trade payables, loans borrowed, bonds issued and redeemable Preference shares. ▪ a contractual obligation to exchange financial instruments underconditions that are potentially unfavourable **e.g.** Derivatives that have a negative payoff. ▪ a non-derivative contract for which the entity is or may be obliged to **deliver** a variable number of the entity's own equity instruments **e.g.** a contract with supplier to deliver our own shares/options (variable number or fixed amount).
An Equity instrument is any **contract** that evidences a **residual interest** in the assets of an entityafter deducting all of its liabilities **e.g.** Ordinary shares, Preference Shares & share options issued by an entity.

3.1 Definitions

A **Derivative** is a financial instrument with all three of the following characteristics:

(a) **its value changes in response to the change in** a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or similar variable (called the '**underlying**');

(b) it requires **no or little initial net investment** relative to other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is **settled at a future date**.

e.g. options, forward contracts, future contracts, swap contracts etc.

3.2 Classification and measurement

3.2.1 Introduction

IPSAS 41 requires lenders to have 3 categories for classification and measurement of Financial Assets:

-Financial Assets at fair Value through Other Comprehensive incomes (IFRS), Net assets (For those under IPSAS) (When we invest in shares and bonds)

-Financial Assets at fair Value through Profit or Loss (Surplus or deficit) (Again some shares and bonds and also derivatives)

-Financial Assets at Amortized cost (Some types of bonds)

3.2 Classification and measurement

3.2.1 Introduction

IPSAS 41 requires lenders to have 2 categories for classification and measurement of Financial Liabilities:

-Financial Liabilities at fair Value through Profit or Loss (Surplus or deficit) (When an entity issues/borrows a loan that is listed on the exchange and derivatives)

-Financial Liabilities at Amortized cost (Mostly payables and other types of loans).

3.3 Classification and Measurement

Initial and Subsequent Measurement of Financial Assets			
Category	Initial measurement	Subsequent measurement	Changes
FVPL	Fair value	Fair value	Change in Fair Value > PoL
FVOCI (Equity)	Fair value + transaction costs	Fair value	Change in Fair Value > OCI
FVOCI (Debt)	Fair value + transaction costs	First, include effectiveinterest Secondly, Change to FV	Effective Interest > PoL Change in Fair Value > OCI
Amortized cost (AC)	Fair value+ transaction costs	Amortized cost	Effective Interest > PoL

Initial and Subsequent Measurement of Financial Liabilities			
Category	Initial measurement	Subsequent measurement	Changes
FVPL	Fair value	Fair value	Change in Fair Value > PoL
Amortized cost (AC)	Fair value - transaction costs	Amortized cost	Effective interest > PoL

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3.4 Derecognition

The lender should derecognize a financial asset when:

(i) the contractual rights to the cash flows have expired, e.g. when an option held by the entity has expired worthless or,

(ii) the financial asset has been sold in substance (i.e. risk and rewards transferred), for example if an entity sells an investment in shares and enters into a total return swap with the buyer, the buyer will return any increases in value to the entity or the entity will pay the buyer for any decrease in value. In this case the entity has retained substantially all of the risks and rewards of the investment, which therefore should not be derecognized.

3.4 Derecognition

The borrower should derecognize a financial liability when it is:

-Discharged e.g. paid in cash or other consideration

-Cancelled e.g. by operation of law

-Expired e.g. by passage of time

On derecognition, the difference between the carrying amount of the asset or liability and the amount received or paid for it should be recognized in the profit or loss or surplus or deficit.

3.4 Impairment of Financial Assets

Impairment is when a Financial Asset cannot be recovered or will likely not be recovered. Based on prudence grounds and just like other assets, IPSAS 41 requires that an entity provides for impairment losses or recognizes impairment losses on financial assets. For example, for loans and trade receivables, IPSAS 41 suggests a criteria for computing expected credit losses (ECL).

3.4 Impairment of Financial Assets

The impairment model follows a three-stage approach based on changes in expected credit losses of a financial instrument that determine the recognition of impairment, and where relevant the recognition of interest revenue. However, IPSAS 41 also recommends a simplified approach to some financial assets such as receivables where the expected credit loss is already based on the entire credit period (not necessarily 12 months).

3.4 Impairment of Financial Assets

2018	Gross maximum exposure	12 months expected credit losses stage 1			Lifetime expected credit losses- stage 2		Credit impaired stage 3
		DG1 – 9	DG10 – 19	DG 20 – 21	DG 20 – 21	DG10 – 19	DG 20 – 21
Balances with Central Bank of Kenya	17 718	16 951	767	-	-	-	-
Investment securities designated at fair value through other comprehensive income	63 289	64 138	(849)	-	-	-	-
Loans and advances to banks	6 572	1 938	4 634	-	-	-	-
Balances due from group companies	9 126	9 126	-	-	-	-	-
Other assets	9 879	9 879	-	-	-	-	-
Loans and advances to customers	187 580	5 013	158 056	1 467	3 516	8 685	10 843
Total gross maximum exposure to credit risk	**294 164**	**107 045**	**162 608**	**1 467**	**3 516**	**8 685**	**10 843**
Expected credit losses	(10 286)	(152)	(2 905)	(27)	(403)	(996)	(5 803)
Total financial assets per the statement of financial position	**283 878**	**106 893**	**159 703**	**1 440**	**3 113**	**7 689**	**5 040**

3.4 Impairment of Financial Assets

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Simplified Approach for short term trade receivables

(i) Recognition of only 'lifetime expected credit losses' (i.e. stage 2)

(ii) Expected credit losses on trade receivables can be calculated using provision matrix (e.g. geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer)

(iii) Entities will need to adjust the historical provision rates to reflect relevant information about current conditions and reasonable and supportable forecasts about future expectations.