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Accounting Update 2020

Presenter: **Caryn Maitland** CA(SA)

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Presenter

Caryn Maitland

Caryn is a qualified CA(SA and RA, who has lectured extensively at UKZN (and other institutes) where she lectured Advanced Financial Accounting up until 2011 as well as co-ordinating the module on the Pietermaritzburg campus and was appointed Section Head of Financial Accounting and Deputy Head of the School of Accounting (managing the Pietermaritzburg campus) prior to leaving UKZN.

She has conducted independent workshops and seminars for professional accountants since 2006 on various topics and has consulted on a number of technical issues. Since January 2011, she has focused on her own business as technical freelance consultant and trainer to those working within the accounting profession. Caryn is a technical advisor to the SAICA Eastern Region Midlands District, Northern District and Southern District Associations, as well as the Small Practice Interest Group in Durban – specialising in financial reporting (IFRS, IFRS for SME's and general accounting), assurance, legislation and ethics. Caryn has a passion for Corporate Governance, which together with her Companies Act specialism and Financial Management for Non Financial Management lecturing background, has served her well in consulting and advising various Boards of Directors in recent years.

Caryn is also a platform presenter for various institutes as well as many small to medium accounting practices across the country and into Southern Africa. Maitland was appointed as a visiting Associate Professor to the University of Limpopo tasked with mentoring their Financial Accounting staff (Aug 2011 to Dec 2013).

Maitland's passion is IFRS and IFRS for SME's and was delighted at the opportunity granted in 2013 to serve on the APC subcommittee constituted to investigate the need for Micro GAAP and the role of IFRS for SME's for small and medium sized practitioners. Caryn, also serves on the Joint Accountants, Auditors and Attorneys Committee of SAICA, and is part of the School Governing Body project initiated by SAICA in KwaZulu-Natal, and has been appointed as an alternative member to the APC in June 2020

Caryn was elected as the first woman Chairperson for the Midlands District Association for SAICA in 2018 and also serves on the Eastern Region SMP Committee as well as the Local Subvention Committee for SAICA. In 2019 Caryn was appointed to the SAICA Eastern Region Council. As someone who is committed to environmental affairs, Caryn serves as a non-executive director for the Institute of Natural Resources, a Non Profit Company focusing on research. Since 2018 Caryn has worked extensively with commerce and industry, assisting analysts, directors and other users of financials to interpret, prepare, analyse and forecast based on the results of financial statements.

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What's on the Agenda?

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IMPACT OF COVID-19 ON THE FINANCIALS

Covid 19 and AFS

- ***“Never let a good crisis go to waste” (Winston Churchill)***
- ***“The secret of crisis management is not good vs. bad, it’s preventing the bad from getting worse” (Andy Gilman)***

Areas impacted

- Going concern
- Subsequent events
- Impairments
    - Goodwill
    - Assets
    - Financial assets
- Accounting for estimates – changes in…

- Restructuring of businesses
  - Business combinations
- Fair values of assets
  - operational and investment
- Provisions
  - Onerous Contracts

- Impact of Forex
- Revenue
  - Contractual obligation
  - Forecasts
- Leases

Disclosure Challenge

- Going concern vs Subsequent Event
  - Adjusting or non adjusting??
- Going concern basis
  - Basis of preparation
  - Audit report
  - Directors Report
  - Notes to AFS

Going concern considerations

- **SUBSEQUENT EVENT**
- Loss of revenue
- Onerous contracts
- Impairments to assets
- Goodwill impairments
- Relief measures
- Access to supply
- Contractual penalties for failure to preform
- Valuations of assets
- Forex

Impact on Impairments

- Cost accounting only
  - Goodwill,
  - Tangible assets,
  - Financial assets (later)
- Net realisable value vs Carrying amount
- Value in use
- Fair value less cost to sell
- Intention towards assets
- Cash generating units

Indicators of Impairment

- IFRS for SME – only when there is an indicator
- IFRS: Annual reviews
  - Acquired goodwill
  - Indefinite useful intangible asset
  - Intangible assets not yet available for use

External sources of information

- Significant decline in assets market value
- Significant adverse current or future changes in
  - the technological, market, economic or legal environment
  - in which the entity operates or
  - The market to which the asset is dedicated
- Increase in market interest rates, or other market rates of return on investments (decrease in RA)
- CV of net assets exceed entity’s market capitalisation

Internal sources of information

- Evidence of obsolescence or physical damage
- Current or future adverse changes in the extent or manner in which the asset is intended to be used
- Internal reports indicate that the economic performance is or will be **worse than expected**

- **Indicator of worse than expected performance**
  - Acquisition costs or subsequent expenses higher than originally expected
  - Significantly worse actual net CF’s or operating profits
  - Significant decline in budgeted net CF’s or operating profits
  - Existence of loss when current and prior figures aggregated
  - Actual CF’s are materially less than estimated before discounting

Forecasting challenges with C-19

- Over what timeline????
- cash flows implications
- Relooking at business model, costs and expenses
- Access to financing
- Payment holidays
- What discount rate??

Estimates

- Objective : Consistency
  - Prescribe criteria for selecting policies, treatments and disclosures of changes and errors
  - Prepare and present AFS on a consistent and comparable basis
  - All items of income and expense recognised to profit or loss, unless otherwise stated
  - Prospective vs. retrospective

Changes in Accounting Estimates

- Estimates require revision
- Can’t distinguish btn Δ in Acc policy or Δ in estimate – treat as the latter
- Methods
    - Reallocation method
    - Cumulative catch up method
- Need to be practical
- reallocation method sanctioned, cumulative catch up superior
- IAS 20 Government Grants

Disclosures

- Nature of change
- Amount of change of estimate that effects current period
- Effect on future reporting periods
- Impracticable?

Restructuring

- Business combinations IFRS 3
- Fair values at date of acquisition
- Liquidation issues
- Loan accounts
- Recoverability issues
- Tax planning – beware unbundling issues

Market/Fair Values

- Is there a market?
- How do you assess cash flows?
- Date specific
- Discount rates??
- Disclosure on impact
- Assumptions and judgements

- Examples:
  - Investment Properties
  - Biological Assets
  - Financial Instruments
- Inventory valuation (NRV)
- Residual values for PPE
  - Impact on useful lives
- Revaluation assessments
- Recoverability of debtors…

Provisions

- Present obligation
  - More likely than not
- Possible obligation??
  - Contingent liabilities
- Constructive vs legal
- Onerous contracts
- IAS 37 does not supercede more specific requirements of other statements

Provisions vs. Contingent Liabilities

Provisions are

- liabilities for which
  - The amount or timing
  - For the expenditure that will be undertaken
  - Is uncertain

Contingent liabilities are

- A <u>possible obligation</u>
  - whose existence will be confirmed by the <u>occurrence or non occurrence</u>
  - Of one or more uncertain events
- A <u>present obligation</u> not recognised because
  - Not probable or
  - Can’t measure with reliability
- Legal claims

Provisions vs. Contingent Liabilities

- Provisions need an <u>OBLIGATING EVENT</u>
  - Gives rise to a present obligation
- Identification of an obligating event
  - Exists where there is no realistic alternative
  - May be a legal obligation
  - May be a constructive obligation
  - Will always involve another party to whom obligation is owed.

Prov vs CL Decision Diagram

Reasonable estimate	Outflow				
	virtually certain	More likely than not	Likely to as not	Less likely	remote
Can	Raise Prov	Raise Prov	Disclose Cont. Liab.	Disclose Cont. Liab.	Ignore
Can’t	Disclose Cont. Liab.	Disclose Cont. Liab.	Disclose Cont. Liab.	Disclose Cont. Liab.	Ignore

- No obligating event = No provision
- Exception 1
  - Uncertain that obligating event has happened
  - Deemed to take place if it is **probable** that there will be an outflow of resources

- Exception 2
  - Contingent liability of an acquiree are raised as liabilities in business combinations
  - Seen as present obligations of the acquirer
  - As implicitly been paid to assume (would have paid more)

Contingent Liabilities and Business Combinations

- CL of acquiree whose fair valued can be measured reliably be recognised by acquirer
  - How much would third parties charge to assume responsibility
  - Probabilities of various outcomes
- Initial recognition = FV
- Subsequent recognition problematic
  - Higher as per IAS 37 and "amortised cost"

Identifying provisions

- Distinguishing feature = uncertainty
  - Timing of future expenditure
  - Amount of future expenditure
- Accrued expenses
- <u>**Obligations arising from past events existing independently of entity's future actions**</u>
- Future operating losses
  - Impairment?

- A provision shall be **recognised** when and ONLY when
  - An entity has a legal or constructive obligation
  - To transfer economic benefits
  - As a result of past events, and
  - A reasonable estimate of the amount can be made

- Present obligation exists when
  - There is no realistic alternative
  - Legal or constructive obligation exist
- Constructive obligation =
  - Valid expectation
  - Protect reputation
  - Judgment required

Measuring provisions

- Best estimate of settlement at Reporting Date
  - Prudent pre-tax basis
  - (careful about being overly conservative)
  - Discount if effects material

- Possible measurement tests
  - How much to settle immediately
  - Probability theory to compute expected value
  - Most likely amount
  - Experts
  - Past experience
- Review each balance sheet date
  - Change in estimate
  - Assess recognition criteria

- Used only for expenditures that related when originally created
- Gains from expected disposals not included, even if closely linked
- Future events
  - Changing technology etc?
- Discounting
  - Record provision at present value

Provisions for restructuring

Defined as a programme

- that is planned and controlled by management and
- Materially changes
  - The business' scope
  - Manner in which business is conducted
- Could be a discontinued operation (notes)
- Business Combination – only existing prov.

- Onerous contracts
  - Lower of cost of fulfilling contract or penalties etc payable if failure to fulfil
- Reimbursement
  - Cant offset against contingent asset (only raised when virtually certain)
  - Expense can be offset in P&L (net recovery)

Disclosure - Provisions

- Description
- Expected timing of outflows
- Indication of uncertainty
- Reimbursements?
- Reconcile OB to CB
- Increases in the discounted amount as a result of
  - Changes in discount rate
  - Passage of time
- Exception to disclosure
- Subsequent event announcement of restructuring

Disclosure – Contingent Liabilities

- Unless outflow remote
- Description
- Information obtainable without undue effort or cost
  - Financial effect
  - Indication of uncertainties
  - Reimbursements?
  - Exception

Rare exception to rules (prov, CL and CA)

- Would disclose seriously prejudice the position of the entity
- In negotiations with another party
- In respect of a dispute?

- If so, disclose:
    - General nature of dispute
    - Fact that info has not been disclosed
    - Reason why.

Forex

- Impact of inventory
- Gains and losses in P&L
- Hedging
- Financial management
- Risk disclosures

Revenue and leases

- To discuss under IFRS 15 and 16

IASB Workplan

Workplan

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IAS 8 Change in policies and estimates

IAS 1 Presentation of AFS

- Classification of currents vs non current liabilities

Disclosure Project continues

Sustainability Reporting

Other minor amendments

PRACTICAL CONSIDERATIONS

IFRS 16: Steps management need to take

- Identify potential leases per the lease definition in the standard
- Inspect all lease contracts and agreements available. Management need to be aware that leases could be in disguise in other agreements or contracts as there may be optional accounting treatments for these leases under the transitional arrangement from IAS 17 to IFRS 16.
- Assess which party has control over the asset (lessor or lessee) and the impact of any terms and conditions of the agreement.
- Identify the discount rate to be utilised in the leased liability calculations, that is the entity's incremental borrowing rate if the internal rate within the lease is not available.
- Extract and identify lease payments, including contingent rentals, conditions for increase, etc
- Assess managements intention to renew the lease. Consider ability and intention to renew or terminate the lease and cost implications thereof.

- Identify the discount rate to be utilised in the leased liability calculations, that is the entity’s incremental borrowing rate if the internal rate within the lease is not available.
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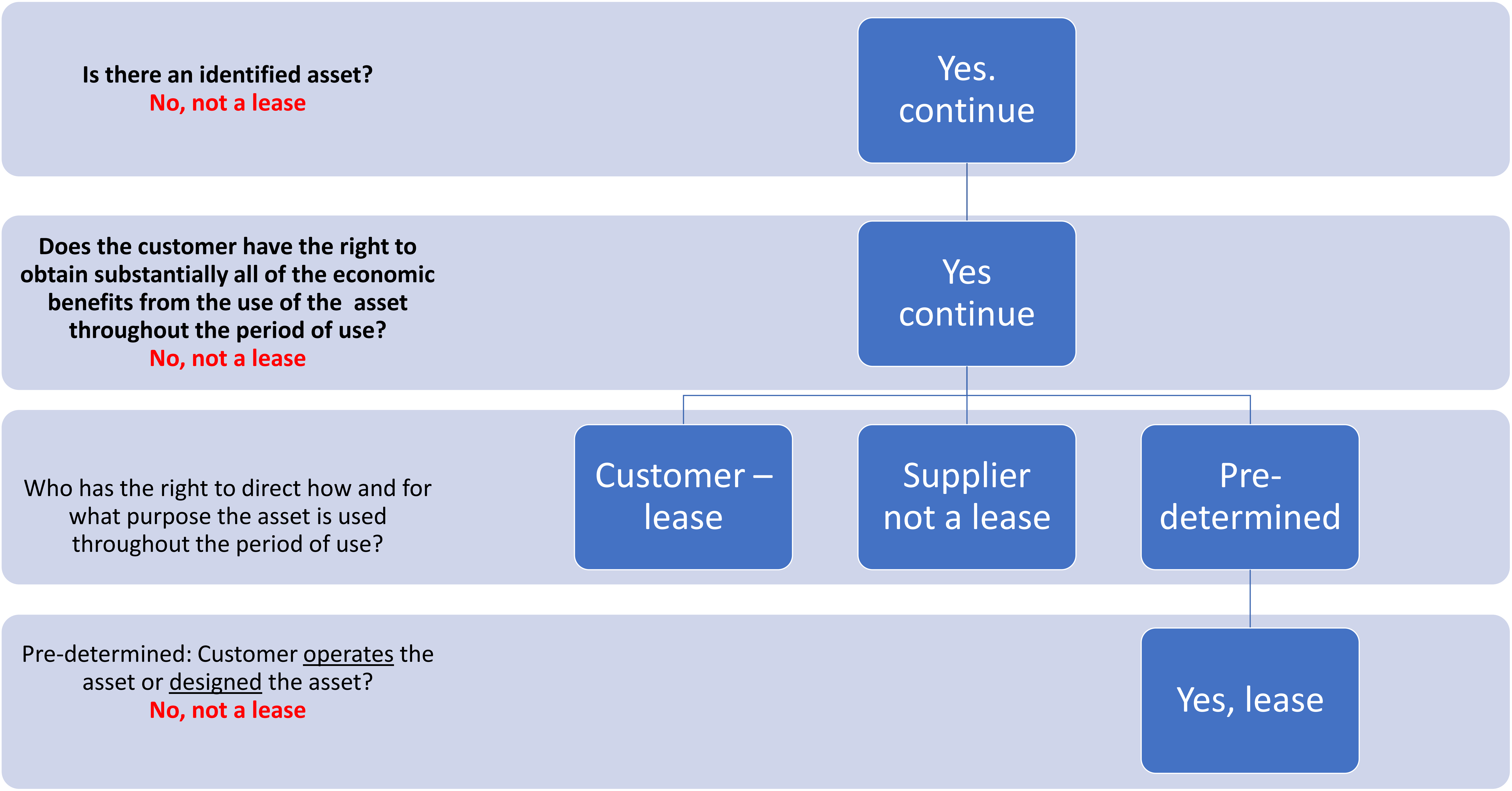
First time adoption

- Only leases that have been previously identified as at 1 March 2019 as operating or finance leases as per IAS 17 will be reviewed and considered.
- Leases will be accounted for under IFRS 16 from 1 March 2019, any first-time correcting adjustments necessary will be taken to opening retained earnings of the current year once the leases have been appropriately capitalised.
- The necessary disclosures will be made for users to appreciate the impact of the first-time adoption of IFRS 16.

Evaluating whether a contract/agreement contains a lease



Incremental Borrowing Rate

- Need
  - when the interest rate implicit in the lease cannot be readily determined
  - Using simplified first time adoption method
- *Defined as*
  - *the rate of interest that a lessee would have to pay*
  - *to borrow over a similar term, and with a similar security,*
  - *the funds necessary to obtain an asset of a similar value to the right-of-use asset*
  - *in a similar economic environment'*

6 factors necessary to determine the IBR

- The Lessee entity (operating in economic environment)
- Currency (Pay to borrow)
- Economic environment
- Term of lease
- Asset Type
- Level of indebtedness (consideration with respect to value of leased liability/ROUA)

3 key components

- Reference rate
  - Currency (only a challenge if lease is in a foreign jurisdiction which have different risk-free rates)
  - Economic conditions (Countries operating in distressed, unusual or challenging circumstances may not have a stable risk-free rate)
  - Term (needs to match the term of the lease, consideration could be given to a weighted average risk-free rate to determine an appropriate rate)

- Financing spread adjustments
  - Term of the lease
  - Level of indebtedness of the lessee. Different gearing structures will lead to different IBRs
  - Lessee entity (including credit risk)
  - Economic environment (business and sector)
- Lease specific adjustments
  - Asset type (including security)

The Lease Term

- the non-cancellable period of the lease
- plus periods covered by an option to extend or
- an option to terminate
- if the lessee is ***reasonably certain*** to exercise the extension option or not exercise the termination option

“Reasonably certain”

- Contractual terms and conditions for optional periods compared with market rates
- Significant leasehold improvements undertaken
- Costs relating to the termination of the lease and signing a replacement lease.
- The importance of the underlying asset to the lessee’s operations:

Lease payments

- Fixed payments (including in-substance fixed payments), less any lease incentives receivable;
- variable lease payments that depend on an index or a rate;
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase option (if the lessee is reasonably certain to exercise that option); and
- payments of penalties for terminating the lease (if the lease term reflects the lessee exercising the option to terminate the lease).

Contingent payments

- <u>Variable lease payments based on an index or a rate:</u>
  Variable lease payments based on an index or a rate (for example, linked to a consumer price index, a benchmark interest rate or a market rental rate) are part of the lease liability.
- <u>Variable lease payments based on any other variable:</u>
  Variable lease payments not based on an index or a rate are not part of the lease liability.
- <u>In-substance fixed payments:</u>
  Lease payments that, in form, contain variability but, in substance, are fixed are included in the lease liability. The standard states that a lease payment is in-substance fixed if there is no genuine variability

- *If payments are initially structured as variable lease payments linked to the use of the underlying asset*
- *But*
- *the variability will be resolved at a later point in time,*
- *those payments become in-substance fixed payments when the variability is resolved*

To recap

- *Identify the incremental borrowing rate*
- *Identify the lease term*
- *Forecast lease payments*
- Present value – ROU Asset and liability
- Test asset for impairment
- Calculate deprecation and finance costs
- Change of estimates
- Onerous lease considerations
- Deferred tax
- First time adoption – smoothing provision IAS17

IFRS 9 Financial Assets

- Financial Assets
  - Debtors vs long term loans
  - Related vs unrelated debt
  - Recoverability

Impairment and IFRS 9

- Credit crisis – delayed recognition of credit losses on loans (and other financial instruments) seen to add to the problem
  - IAS 39 looked for trigger event
  - Practice took this to be actual default
  - Incurred loss model vs postponed loss
  - Designed to prevent income smoothing through reserves
  - Multiple models in IAS 39 confusing

New single impairment model

- Objective – provide more useful info on entity’s expected credit losses on financial instruments
- Requires entity to recognise expected credit losses at all times
  - Update amount at each reporting date to reflect change in the credit risk of financial instruments
- Forward looking
  - Eliminates threshold for recognition (no need for trigger event)

- More timely info required
  - Only consider losses that arise from past events and current condition
- Can not look at possible future losses even when expected
- Subsequent events issue….
- More info given to consider when determining expected credit losses
  - Reasonable and supportable evidence
  - Available without undue cost or effort
  - Include historical, current and forecast info

- Improved disclosure for impairments about
  - Expected credit losses and credit risk
- Explain
  - basis of expected credit loss calculations
  - How they manage expected credit losses
  - Assess changes in risk

Accounting for impairment

- Expected credit losses consider amount and timing
- 12 month expected credit loss(ECL)?
  - Default events possible on financial instrument within 12 months of reporting date
  - Effect of entire credit loss weighted against probability of happening
  - Not cash shortfalls
  - Not credit losses on assets expected to actually default in next 12 months = lifetime ECL

- Lifetime expected credit loss(ECL)?
  - Expected present value of losses that arise if a borrower defaults throughout life of asset
  - Beyond the next 12 months
  - Expects to be paid in full but later than when contractually due

- Stage 1-3

- Stage 1
  - On purchase 12 month ECL recognised to P&L (allowance acc recognised)
  - Interest revenue = effective interest on gross CA

- Stage 2
  - Expected credit risk increases significantly & quality of credit not seen as low
  - Lifetime ECL raised only if credit risk increases significantly since purchase
  - Interest revenue = effective interest on gross CA

- Stage 3
  - Credit risk increases to the point that financial asset is **credit impaired**…
  - Financial assets assessed on an individual basis
  - Lifetime ECL
  - Interest revenue = effective interest on amortised cost

- Measuring expected credit losses?
  - PV of expected cash shortfalls
  - Probability weighted outcome (possibility will or will not occur)
  - Time value of money
  - Reasonable and supported info (no undue cost or effort)

- Information to use?
  - Past, present and forecasts
  - No measurement prescribed
  - More than 30 days past due – rebuttable presumption
  - Low credit risk at reporting date?

Financial Assets

- Trade receivable impairment
- Loan receivables
- Contract receivables
- Lease receivables

- Significant financing element?
  - No – Simplified approach
  - Yes – Simplifies or general approach

Impairment of trade receivables

- Step 1 Determine the appropriate groupings of receivables into categories of shared credit risk characteristics.
- Step 2 Determine the period over which historical loss rates are obtained to develop estimates of expected future loss rates.
- Step 3 Determine the historical loss rates.
- Step 4 Consider forward looking macro-economic factors and adjust historical loss rates to reflect relevant future economic conditions.
- Step 5 Calculate the expected credit losses.

General Impairment method

- Improved disclosure for impairments about
  - Expected credit losses and credit risk
- Explain
  - basis of expected credit loss calculations
  - How they manage expected credit losses
  - Assess changes in risk

General Formula
ECL = PD x EAD x LGD

- Probability of Default (PD)
  - Risk that that borrow will be unable or unwilling to repay its debt in full or on time
- Exposure at Default (EAD)
  - The GROSS exposure under a facility upon default of a borrower
  - In general, seen as an estimation of the extent that a lender may be exposed to a counter party in the event of that counter party's default
  - Equal to current amount outstanding for fixed exposures, unsecured receivables = full balance
- Loss given default
  - Share of an asset that is lost when an asset defauls

- Recon
  - Opening to closing balance of allowance
  - Separate out 12 month loss allowance from lifetime loss allowance
  - This is in addition to recon of balances of FI subject to impairment
  - Users need to understand reason for changes (changes in credit risk or increased lending)
  - Users want info of credit risk of FA
    - by rating grades and
    - FA where contractual cash flows have been modified

- Stratify population
- Risk management – credit policy
  - proactive
- Companies Act
  - Fiduciary duties of directors

IFRS 15

- Cost of sales vs operating expenses
- Streams of income
- Revenue
- Other income
- Recoveries
- Rebates
- Interest revenue

QUESTIONS?

Formal Q&A Session

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We will now take a **quick comfort break** before we discuss some questions received during the webinar.

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technicalquestions@accountingacademy.co.za

E-mail general comments to info@accountingacademy.co.za

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Thank you for your participation!

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