IFRS NEWSLETTER

IFRS 9 Financial Instruments and IFRS 15 Revenue from contracts with customers

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INTRODUCTION

New International Financial Reporting Standards (IFRS) introduce significant changes. This newsletter focuses on IFRS 9 and IFRS 15, both of which become effective for accounting periods beginning on or after 1st January 2018, and each of which incorporate fundamental changes that will impact financial reporting for organisations that report under full IFRS, and aims to provide an overview of these standards along with practical considerations for their implementation.

A subsequent newsletter will deal with IFRS 16 – Leases, which becomes effective for accounting periods beginning on or after 1st January 2019

IFRS 9 – FINANCIAL INSTRUMENTS

The IASB published IFRS 9 – Financial Instruments in July 2014. It replaces IAS 39 - Financial Instruments: Recognition and Measurement.

So how will it impact entities generally?

- Whilst IFRS 9 was written primarily with financial institutions in mind, it will have an impact on all entities that have financial assets (e.g. trade receivables) on their balance sheet.
- Financial assets may need to be measured differently, as they will be classified on the basis of the cash flows associated with the asset and the entity's business model instead of whether they meet defined criteria for different categories of financial asset, as they are currently.
- Impairment losses will be recognised earlier due to the introduction of a new impairment loss model, which is based on expected rather than incurred losses.
- The new hedging requirements are easier to interpret and are more closely aligned with the risk management objectives and strategies of the business. Specifically, there is more flexibility to apply hedge accounting to groups of items, including net positions, so you can adopt hedging accounting on a more 'entity wide' basis. This could make hedge accounting a more accessible and worthwhile approach for some businesses. However, since very few entities in Kenya currently apply hedge accounting, this newsletter does not cover the new requirements.
- There will be no impact on the recognition and measurement of financial liabilities unless a liability has been designated as at fair value through profit or loss, in which case changes in the fair value of the liability attributable to changes in credit risk of the borrower are presented in other comprehensive income.

Classification and measurement of financial assets

Classification and measurement of financial assets will be based on two criteria:

- The entity's business model for managing the financial assets; and
- The contractual cash flow characteristics of the financial asset.

Financial assets can be measured at amortised cost only if both:

- The contractual terms of the asset give rise on specified dates to cash flows that are solely payments of principal and interest; and
- The asset is held within a business model whose objective is to hold assets in order to collect the contractual cash flows.

Trade receivables, fixed deposits, and loans and advances with fixed repayment terms are likely to qualify for measurement at amortised cost. Investment in government securities would also qualify if the intention is to hold them to collect the cash flows. The above criteria are more flexible than IAS 39's 'Held-to-maturity' criteria: some sales of such assets prior to maturity to meet a cash requirement are acceptable provided the business model continues to have the objective of holding the assets to collect the contractual cash flows.

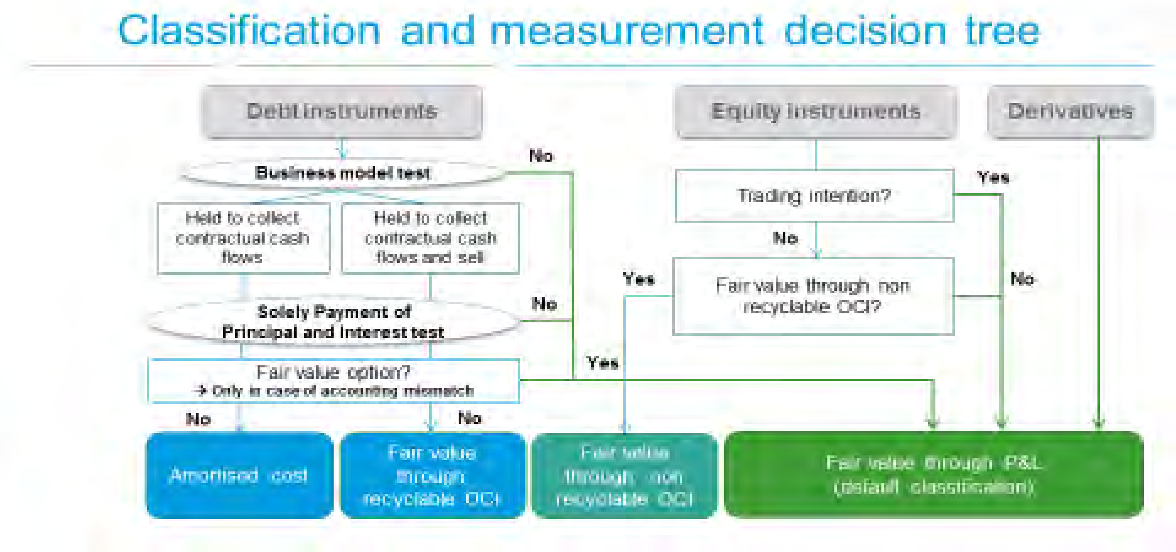
All other financial assets have to be measured at fair value. For debt instruments for which the contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest, and which are held in a business model whose objective is achieved by both collecting contractual cash flows and selling the assets, the changes in fair value are recognised in other comprehensive income. Interest income has to be recognised in profit or loss. On sale of the asset, the cumulative gain or loss would be reclassified to profit or loss (similar to the IAS 39 'Available-for-sale' classification).

For investments in equities not held for trading, excluding investments in subsidiaries, associates or joint ventures, the default classification is at fair value through profit or loss. However, the entity can make an irrevocable election on initial recognition to classify the investment as at fair value through other comprehensive income, with dividend income recognised in profit or loss. In this case, the changes in fair value are not reclassified to profit or loss on realisation.

All other financial assets, including those held for trading, derivatives, and hybrid instruments have to be measured at fair value through profit or loss.

For financial assets that qualify to be measured at amortised cost or at fair value through other comprehensive income, there is still the option of measuring them at fair value through profit or loss, if doing so eliminates or significantly reduces an accounting mismatch.

The classification and measurement of financial assets under IFRS 9 is summarised in the following decision tree:



Transition

Changes in classification and measurement should be applied retrospectively at 1 January 2018 (assuming a 31st December year-end), but comparatives should be restated only if possible to do so without the use of hindsight. If an asset previously classified as available-for-sale has to be reclassified as at fair value through profit or loss, then the cumulative fair value gains or losses should be transferred from the fair value reserve in equity to retained earnings.

What action do you need to take?

- Identify the financial instruments that you currently have and note how each one is measured.
- For financial assets that were in the scope of IAS 39, identify the nature of the cash flows associated with them and the business reasons for holding them, as this will impact on their measurement.
- If you have investments in equity instruments, decide whether you want to elect to continue to measure them at fair value through other comprehensive income, or reclassify them to fair value through profit or loss.

Classification and measurement of financial liabilities

All financial liabilities should, similar to IAS 39, be measured at amortised cost, except for the following, which should be measured at fair value through profit or loss:

:

- Liabilities held for trading
- Derivatives

- A financial liability designated on initial recognition as at fair value through profit or loss because:
    - Doing so eliminates or significantly reduces an accounting mismatch; or
    - It forms part of a portfolio which is managed and evaluated on a fair value basis
- Financial guarantee contracts
- Commitments to provide loans at below market rate interest,

Impairment of financial assets

The guiding principles of IFRS 9 on impairment are that:

- Provisions should be based on expected credit losses, rather than incurred credit losses
- Provisions should be responsive to changes in information that impact credit expectations (i.e. forward looking); but
- Credit losses should be based on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and forecast information.

Provisions for impairment losses are required for:

- Financial assets carried at amortised cost
- Lease receivables (not otherwise in the scope of IFRS 9)
- Debt instruments at fair value through other comprehensive income
- Loan commitments and financial guarantee contracts.

IFRS 9 requires that each of the above assets be placed in one of the following three categories:

Stage 1	Assets for which credit risk has not increased significantly since initial recognition
Stage 2	Assets for which credit risk has increased significantly since initial recognition
Stage 3	Assets for which there is evidence of impairment

For stage 2 and stage 3 assets, provision should be made for lifetime expected credit losses, the difference being that for stage 2 assets, interest continues to be recognised based on the gross carrying amount (i.e. before provision) whereas for stage 3 assets interest should be recognised on the net carrying amount. Lifetime expected credit losses are generally expected to be recognised before default occurs, i.e. assets are not expected to move directly from stage 1 to stage 3, although there might be exceptional situations when this occurs.

Lifetime expected credit losses are defined as the expected credit losses that result from all possible default events over the expected life of the financial asset. Expected credit losses should be an unbiased probability-weighted estimate of credit losses determined by evaluating a range of possible outcomes. In other words:

Expected credit loss = probability of default x amount of credit loss

Where the amount of credit loss is the present value (discounted at the assets effective interest rate) of the difference between the contractual cash flows and the cash flows that the entity expects to receive.

For stage 1 assets, provision should be made for 12-month expected credit losses. These are the portion of lifetime expected credit losses that represent the expected credit losses that result from default events that are possible within 12 months from the reporting date.

When determining whether there has been a significant increase in credit risk (i.e. the asset needs to be in Stage 2 rather than Stage 1), various factors need to be considered, based on reasonable and supportable information, such as whether there has been:

- An actual or expected significant change in FI's external credit rating
- An actual or expected internal credit rating downturn
- An actual or expected significant change in the operating results of the borrower
- Adverse changes in existing or forecast business, financial, or economic conditions
- A significant change in the value of the collateral supporting the obligation.

In addition, there is a rebuttable presumption that there has been a significant increase in credit risk if the financial asset is more than 30 days past due.

There is also a rebuttable presumption that if a financial asset is more than 90 days past due, then it is impaired and should be in Stage 3.

IFRS 9 requires that for trade receivables and contract assets that do not contain a significant financing component, lifetime expected credit losses should be recognised from day one. For trade receivables and contract assets that have a significant financing component, and lease receivables, an entity can opt, as a simplification, to recognise lifetime expected credit losses from day one.

There will be situations when it is impracticable to assess credit risk and impairment losses on an individual asset basis, and IFRS 9 allows this to be assessed on a collective, or portfolio, basis, provided the assets are grouped on the basis of shared credit risk characteristics.

Transition

The requirements of IFRS 9 relating to impairment should be applied retrospectively, so it is likely that an adjustment to retained earnings at 1st January 2018 will be required. However, restatement of comparatives is not required.

What action do you need to take?

To determine the adjustment required at 1st January 2018 (assuming a 31st December year-end) in respect of expected credit losses, it will be necessary to:

1) Determine the appropriate classification of each financial asset under IFRS 9 (see above)
2) Determine whether there has been a significant increase in credit risk of the financial asset since initial recognition, either on an individual or collective basis.
3) For financial assets where an entity has previously incurred losses (e.g. trade receivables, loans and advances, etc.), extract historical data that will enable estimates of probabilities of default and loss experience to be made. Entities with little historical information may use information from internal reports, information about similar products, or peer group experience for comparable financial instruments, if relevant.

Earlier recognition of impairment losses may impact on key performance indicators and covenant breaches so it is important to identify how the new model will impact these.

For more information on IFRS 9, please get in touch with your usual RSM contact.

IFRS 15: REVENUE FROM CONTRACTS WITH CUSTOMERS

IFRS 15, which replaces IAS 18 Revenue, IAS 11 Construction Contracts and their associated interpretations, also comes into effect for periods commencing on or after 1 January 2018.

So how will it impact entities generally?

Revenue recognition may be accelerated or deferred for transactions with multiple components, variable considerations or licences. Key financial ratios may be impacted affecting expectations and contractual covenants.

Tax changes caused by adjustments to the timing and amounts of revenue, expenses and capitalised costs may require revised tax planning.

DEFINITIONS

Revenue – income arising in the course of an entity's ordinary activities.

Contract - An agreement between two or more parties that creates enforceable rights and obligations.

Customers - A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

SCOPE

Applies to all contracts with customers except:

- Leases (IAS 17)
- Financial instruments and other rights and obligations within the scope of IFRS 9 (IAS 39), IFRS 10, IFRS 11, IAS 27, IAS 28;
- Insurance contracts (IFRS 4); and
- Non-monetary exchanges between entities within the same business to facilitate sales.

5 STEP MODEL

STEP ONE – IDENTIFY THE CONTRACT

IFRS 15 requires contracts to have all of the following attributes:

1. Parties to the contract have approved it and are committed to perform;
2. Each party's rights to the goods/services transferred are identified;
3. The payment terms are identified;
4. The contract has commercial substance; and
5. It is probable that an entity will collect the consideration (considering only the customer's ability and intention to pay).

If each party to the contract has a unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties), no contract exists under IFRS 15.

IFRS 15 provides guidance about contract combinations and contract modifications, too.

Contract combination happens when you need to account for two or more contracts as one contract and not separately. IFRS 15 sets the following criteria for combining contracts if they are entered into at (or near) the same time, with the same customer:

- The contracts are negotiated as a package with a single commercial objective
- The consideration for each contract is interdependent on the other; or
- The overall goods or services of the contracts represent a single performance obligation.

A **Contract modification** is only accounted for if it has been approved, and creates new, or changes existing, enforceable rights and obligations. Contract modifications are accounted for as a *separate contract* if, and only if:

- The contract scope changes due to the addition of *distinct* goods or services; and
- The change in contract price reflects the *standalone selling price* of the distinct good or service.

Contract modifications that are **not** accounted for as a **separate contract** are accounted for as either:

(i) Replacement of the original contract with a new contract (if the remaining goods or services under the original contract are distinct from those already transferred to the customer)

(ii) Continuation of the original contract (if the remaining goods or services under the original contract are distinct from those already transferred to the customer, and the performance obligation is partially satisfied at modification date).

(iii) Mixture of (i) and (ii) (if elements of both exist).

STEP 2 – IDENTIFY THE PERFORMANCE OBLIGATION

Performance obligations are the contractual promise by an entity, to transfer to a customer distinct goods or services, either individually, in a bundle, or as a series over time.

An essential characteristic of a performance obligation is the word ‘***distinct***. Distinct means separable, or separately identifiable, and IFRS 15 sets the following criteria that you must assess in order to determine whether the performance obligation is distinct or not:

(i) *The customer can ‘benefit’ from the good or service* either through use, consumption, or sale (but not as scrap) or held in a way to generate economic benefits. Benefit from the good or service can be either on its own or together with other readily available resources (i.e. those which can be acquired by the customer from the entity or other parties); and

(ii) *The promise to transfer a good or service is separable from other promises in the contract*. This assessment requires judgement, and consideration of all relevant facts and circumstances. A good or service may not be separable from other promised goods or services in the contract, if:

- There are significant integration services with other promised goods or services
- It modifies/customises other promised goods or services
- It is highly dependent/interrelated with other promised goods or services.

STEP 3 – DETERMINE THE TRANSACTION PRICE

The ***transaction price*** is the amount of consideration that an entity expects to be entitled to in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. It is what you expect to receive from your customer in return for your supplies.

The transaction price does not only include what is set out in the contract but needs to take into account the following;

➢ **Accounting for variable consideration** – For example: discounts, rebates, refunds, credits, concessions, incentives, performance bonuses, penalties, and contingent payments.

Variable consideration must be estimated using either:

(i) Expected value method: based on probability weighted amounts within a range (i.e. for large number of similar contracts)
(ii) Single most likely amount: the amount within a range that is most likely to be received (i.e. where there are few amounts to consider).

Variable consideration is only recognised if it is highly probable that a subsequent change in its estimate would not result in a significant revenue reversal (i.e. a significant reduction in cumulative revenue recognised).

- **Accounting for a significant financing component** – The transaction price is adjusted to reflect the cash selling price if the timing of payments specified in the contract provides either the customer or the entity with a significant benefit of financing the transfer of goods or services. A significant financing component does not exist when :
  (i) Timing of the transfer of control of the goods or services is at the customer's discretion
  (ii) The consideration is variable with the amount or timing based on factors outside of the control of the parties
  (iii) The difference between the consideration and cash selling price arises for other non-financing reasons (i.e. performance protection).

  Do not account for any significant financing component if the period between transfer and payment is 12 months or less.

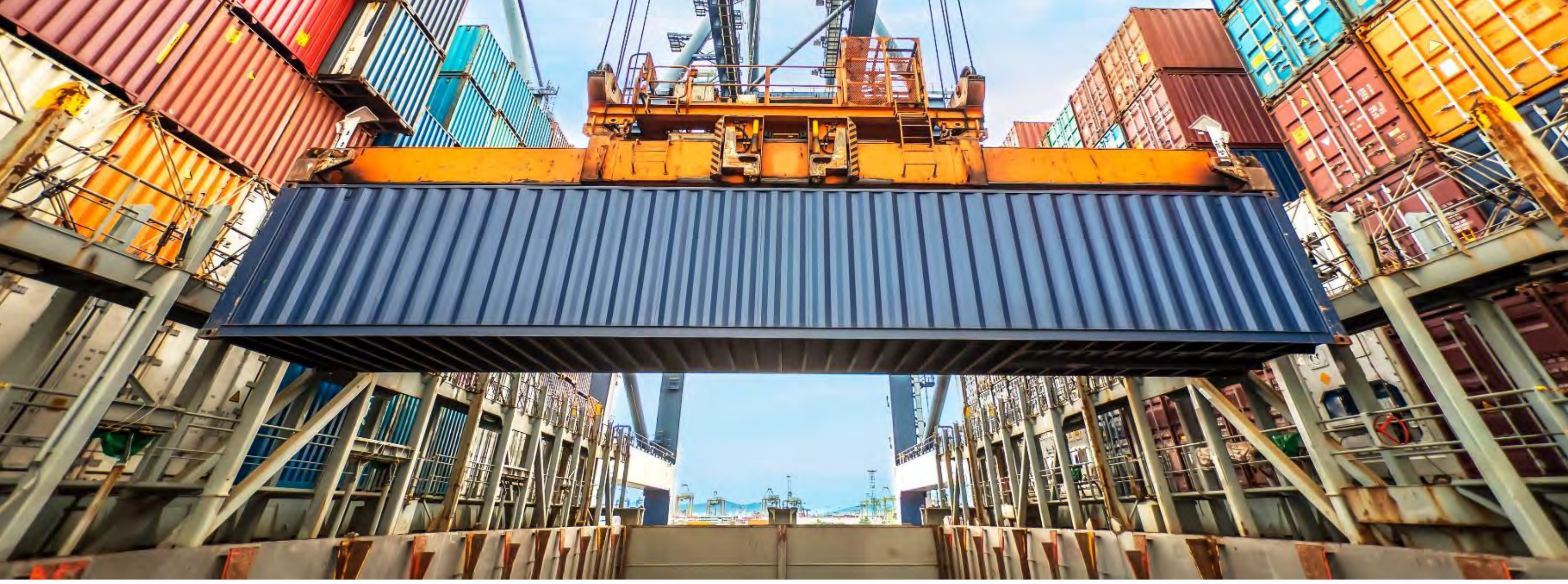
- **Accounting for consideration payable to the customer** – This includes cash paid (or expected to be paid) to the customer (or the customer's customers) as well as credits or other items such as coupons and vouchers. It is accounted for as a reduction in the transaction price, unless payment is in exchange for a good or service received from the customer in which case no adjustment is made.

- **Accounting for non-cash consideration** - Is accounted for at fair value (if not reliably determinable, it is measured indirectly by reference to stand-alone selling price).

STEP 4 – ALLOCATE THE TRANSACTION PRICE TO EACH PERFORMANCE OBLIGATION

The transaction price is allocated to each performance obligation based on their relative **stand-alone selling prices**. If the stand-alone selling price(s) are not observable, they are estimated. Approaches to estimate may include:

(i) Adjusted market assessment approach
(ii) Expected cost plus a margin approach
(iii) Residual approach (i.e. residual after observable stand-alone selling prices of other performance obligations have been deducted). Note that restrictive criteria must be met for approach (iii) to be applied.



There are two exceptions to allocating based on the relative standalone prices.

Discounts are allocated on a proportionate basis, unless there is observable evidence that the discount relates to one or more specific performance obligation(s) after meeting all of the following criteria:

- The goods or services (or bundle thereof) in the performance obligation are regularly sold on a stand-alone basis, and at a discount.
- The discount is substantially the same in amount to the discount that would be given on a stand-alone basis

Variable consideration is allocated entirely to a performance obligation (or a distinct good or service within a performance obligation), if both of the following are met:

- The terms of the variable consideration relate specifically to satisfying the performance obligation (or transferring the distinct good or service within the performance obligation)
- The allocation of the variable consideration is consistent with the principle that the transaction price is allocated based on what the entity expects to receive for satisfying the performance obligation (or transferring the distinct good or service within the performance obligation).

STEP 5 – RECOGNISE REVENUE WHEN (OR AS) THE ENTITY SATISFIES A PERFORMANCE OBLIGATION

The transaction price allocated to each performance obligation is recognised as/when the performance obligation is satisfied, either over time, or at a point in time.

Satisfaction occurs when **control** of the promised good or service is transferred to the customer. '*Control*' is the ability to direct the use of and obtain substantially all of the remaining benefits from an asset (or prevent others from doing so).

Factors to consider when assessing transfer of control:

- Entity has present right to payment for the asset
- Entity has physically transferred the asset
- Legal title of the asset
- Risks and rewards of ownership
- Acceptance of the asset by the customer.

IFRS 15 sets the following criteria when you should recognise revenue **over time**. In all other cases, revenue is recognised at a point in time.

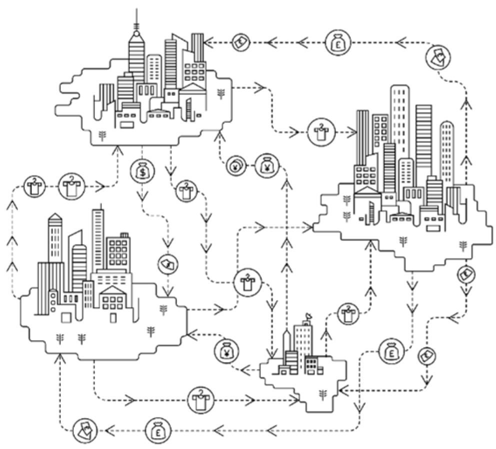
i. The customer simultaneously receives and consumes all of the benefits provided by the entity as it performs. If another entity would not need to substantially re-perform the work already performed by the entity in order to satisfy the performance obligation, the customer is considered to be simultaneously receiving and consuming benefits;

ii. The asset that is created or enhanced is controlled by the customer; or

iii. The vendor does not have an *alternative use* for the asset that it creates or enhances and has an *enforceable right to payment* for performance completed to date

- *Alternative use* assessment requires judgement and consideration of all facts and circumstances. An asset does not have an alternative use if the entity cannot practically (through rework or reduced selling price) or contractually redirect the asset to another customer, Whether or not the asset is largely interchangeable with other assets produced by the entity should also be considered in determining whether practical or contractual limitations occur.
- *Enforceable right to payment* considers both the specific contractual terms and any applicable laws or regulations. Ultimately, other than due to its own failure to perform as promised, an entity must be entitled to compensation that approximates the selling price of the goods or services transferred to date. The profit margin does not need to equal the profit margin expected if the contract was fulfilled as promised.

Revenue that is recognised over time is recognised in a way that depicts the entity's performance in transferring control of goods or services to customers. Methods include:



- Output methods: (e.g. Surveys of performance completed to date, appraisals of results achieved, milestones reached, units produced/delivered, etc.);
- Input methods: (e.g. Resources consumed, labour hours, costs incurred, time lapsed, machine hours, etc.), excluding costs that do not represent the seller's performance.

IFRS 15 sets out application guidance about other areas some of which we summarise below.

Contract costs – Only costs of obtaining a contract that are incremental and expected to be recovered can be recognised as an asset and amortised consistent with the pattern of transfer of the goods or services to which the asset relates. If costs to fulfil a contract are within the scope of other IFRSs (e.g. IAS 2, IAS 16, IAS 38 etc.) apply those IFRSs. If not, a contract asset is recognised under IFRS 15 if, and only if, the costs:

- Are specifically identifiable and directly relate to the contract (e.g. direct labour, materials, overhead allocations, explicitly on-charged costs, other unavoidable costs (e.g. sub-contractors));

- Create (or enhance) resources of the entity that will be used to satisfy performance obligation(s) in the future; and
- Are expected to be recovered.

Other costs are recognised as an expense as incurred e.g. General and administrative expenses, wastage, scrap, and other (unanticipated) costs not incorporated into pricing the contract or costs related to (or cannot be distinguished from) past performance obligations.

Licensing (intellectual property (IP))

(i) If the licence is not *distinct* from other goods or services, it is accounted for together with other promised goods or services as a single performance obligation.
(ii) If the licence is distinct from other goods or services – It is accounted for as a single performance obligation.

Revenue from a distinct licence is recognised *over time* if, and only if:

a. The entity undertakes, or is reasonably expected to undertake, activities that will significantly affect the IP to which the customer has rights;
b. The customer's rights to the IP expose it to the positive/negative effects of the activities that the entity undertakes in (a); and
c. No goods or services are transferred to the customer as the entity undertakes the activities in (a).

Non-refundable upfront fees include additional fees charged at (or near) the inception of the contract (e.g. joining fees, activation fees, set-up fees etc.). Treatment depends on whether the fee relates to the transfer of goods or services to the customer (i.e. a performance obligation under the contract). If yes, recognise revenue in accordance with IFRS 15 (as or when goods or services transferred) and if not, it is treated as an advance payment for the performance obligations to be fulfilled.

DISCLOSURE

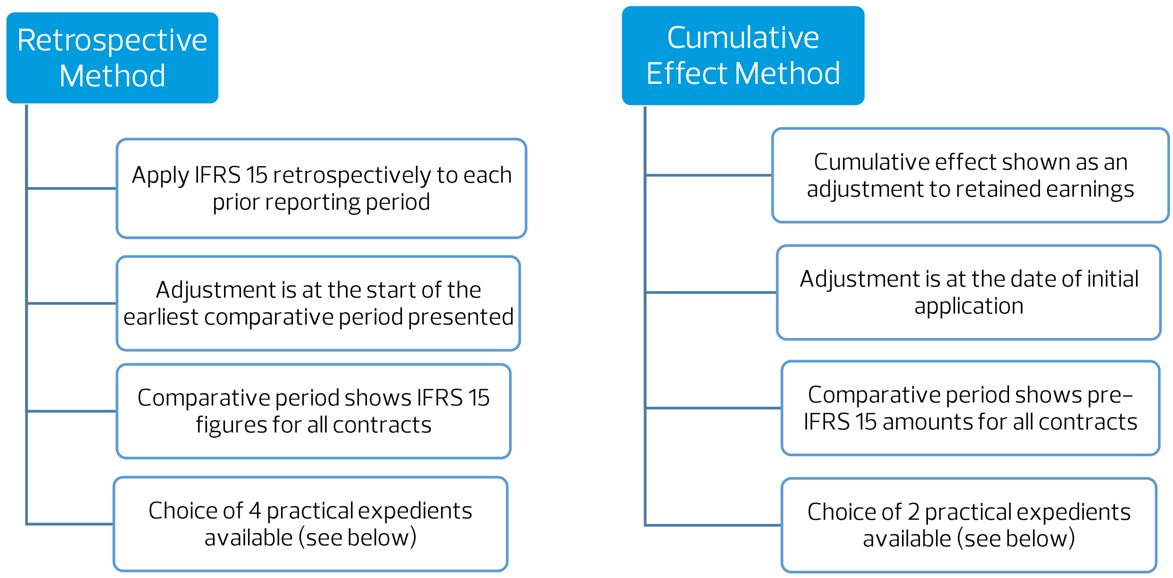
The overall objective is to disclose sufficient information to enable users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Qualitative and quantitative disclosures include:

Contracts with customers (information regarding): • Disaggregation of revenue • Contract assets and contract liabilities • Performance obligations (incl. remaining).		*Significant judgements in determining*: • Performance obligation satisfaction • Transaction price (incl. allocation) • Contract costs capitalised.
Assets recognised from the costs to obtain or fulfil a contract: • Method of amortisation • Closing balances by asset type • Amortisation and impairment.		*Use of practical expedients (related to):* • Significant financing component (12 month) • Contract costs (12 month amortisation).

TAX IMPLICATIONS

- VAT may be payable earlier and taxable profit may be higher due to early recognition of revenue.
- Revenue recognised will be different from that disclosed in the VAT returns. Entities will need to regularly reconcile the same.
- Retrospective application will require entities to account for the tax effect on transition.
- Costs of obtaining a contract that are capitalised may be allowable under the tax regulations, which will affect the taxable profit.
- Collectability may delay recognition of revenue which may not be allowable by the revenue authorities.

TRANSITION



Retrospective Method (Practical expedients)	
PE 1	For completed contracts, an entity need not restate contracts that begin and end within the same annual reporting period or are completed contracts at the beginning of the earliest period presented.
PE 2	For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods
PE 3	For contracts that were modified, an entity need not retrospectively restate the contract for those contract modifications. Instead, an entity may reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when identifying satisfied and unsatisfied performance obligations, determining the transaction price and allocating the transaction price to the satisfied and unsatisfied performance obligations.

PE 4	For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognise that amount as revenue.
Cumulative Effect Method	
PE 1	An entity can choose to apply the requirements in IFRS 15 to only contracts that are not completed contracts at the date of initial application or all contracts at the date of initial application
PE 2	The practical expedient for contract modifications is also available for entities who choose the cumulative effect method.

What action do you need to take?

- Review the 5 step model and consider whether it changes your revenue recognition policies.
- Identify and review the contract terms with a view to identifying the performance obligations.
- Carefully consider the impact of the available transitional options and practical expedients to understand the impact they may have on reported profit, taxation liabilities, covenant arrangements, dividend policy, performance related remuneration and narrative reporting.

For more information on IFRS 15, please get in touch with your usual RSM contact.

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