

TECHNICAL GUIDANCE NO 2018/03/TG01

JULY 2018

IFRS 9 FINANCIAL INSTRUMENTS IMPLEMENTATION GUIDANCE

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1. Introduction

IFRS 9: Financial Instruments (“IFRS 9”) was developed because many users told the International Accounting Standards Board (the “Board”) that the requirements in IAS 39 Financial Instruments: Recognition and Measurement (“IAS 39”) were difficult to understand, apply and interpret. They urged the Board to develop a new standard for the financial reporting of financial instruments that was principle-based and less complex.

The Board intends that IFRS 9 will ultimately replace IAS 39 in its entirety through an IAS 39 replacement project. The Board divided its project to replace IAS 39 into three main phases as follows:

- a. Phase 1: Classification and measurement of financial assets and financial liabilities.
- b. Phase 2: Impairment methodology.
- c. Phase 3: Hedge accounting.

The Institute of Chartered Accountants in Malawi (ICAM) is providing this guidance to assist entities in Malawi in implementing IFRS 9. This guidance covers classification and measurement of financial assets and liabilities and their impairment methodology. It does not cover hedge accounting because hedging instruments are uncommon in the market.

2. Scope and effective date

IFRS 9 is applicable to all items within the scope of IAS 39 and is effective for annual periods beginning on or after 1 January 2018.

3. Classification and measurement of financial instruments

IFRS 9 introduces new classification and measurement requirements for debt instruments which is different in some cases from the requirements of IAS 39. The standard is expected to affect a wide range of financial assets and it is expected to have various impacts on reporting entities.

The standard is expected to affect a wide range of areas including classification and measurement, impairment, transition and disclosures¹ based on the nature of financial instruments held by entities and how they do business or what business models they use.

It is important to note that IFRS 9 will not only affect banks and other financial institutions but all reporting entities.

3.1. Classification model

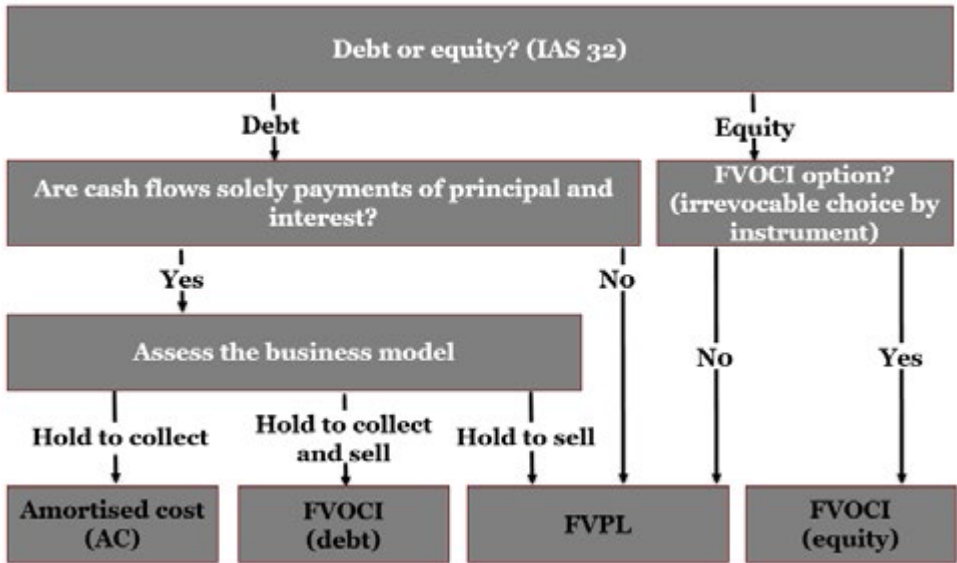
The standard has guidance for the classification of financial assets and financial liabilities

¹ Illustrative disclosures (*Refer to Table 1*)

3.1.1. Classification of Financial Assets

The diagram below has been prepared to guide entities in classifying financial instruments.²

Figure 1: Classification of financial assets



Firstly IFRS 9 requires a **consideration of whether** a financial instrument is either debt or equity as defined by IAS 32.

If the instrument is a debt instrument two further assessments are required. These are:

1. Whether the amounts paid on the instrument are solely payments of principle and interest or SPPI.
2. Considering what type of business is followed by the entity. These entities can either be
 - a. Hold to Collect
 - b. Hold to Collect; and Sell or
 - c. Hold to Sell
3. The above business model results in the following classification
 - a. Hold to Collect: classified as at amortised cost
 - b. Hold to Collect and Sell; classified as at **fair value through other comprehensive income (FVTOCI)** and
 - c. Hold to Sell: classified as at **fair value through profit or loss (FVTPL)**.

3.1.1.1. Further description of the SPPI test and business models

Discussed below is a further description of the SPPI test and various business models in order to explain how classification is determined.

²Examples of financial instruments (*refer to Appendix ii*)

3.1.1.2. SPPI Test

Under IFRS 9, **Principal** is the fair value of the financial asset at initial recognition and any changes to this value due to repayment and new interest charges capitalized and included in the carrying amount of the asset less any impairment for credit risk.

Interest is defined as time value of money, credit risk, basic lending costs and a profit and margin.

Any other variables that do not fit these criteria do not qualify as payments solely of interest and principal. For example in other industries such as mining there could be payments based on the prices of other underlying factors or commodities such as when interest on a loan or amount receivable is dependent on the price of gold.

If cash flows are not SPPI, the financial asset would need to be carried at FVPL. This is the category under IFRS 9 while under IAS 39 it would have been Available for Sale.

3.1.1.3. Business models

1. Hold to Collect

This is a business model whose objective is to hold financial assets to collect their contractual cash flows over the life of the instrument, rather than with a view to selling the assets to generate cash flows.

2. Hold to Collect and Sell

Under this business model, the objective is to both collect the contractual cash flows and later sell the financial asset. In contrast to the hold to collect business model, sales are integral rather than incidental, and consequently this business model typically involves a greater frequency and volume of sales. The volatility arising from the valuation of these instruments is recognized in other comprehensive as opposed to the income statement.

Some financial assets are sold to meet liquidity requirements on a regular basis, in order to meet investment requirement and therefore they will be classified as Held to Collect and Sell.

3. Hold to Sell

The last category of “Held to sell” leads to FVPL and is a “residual” category where the business model is not held to collect or held to collect and sell, and so might also include models where the portfolio of financial assets is managed and performance is evaluated on a fair value basis³. This business model is indicated of a more speculative approach that focuses on the following:

- a. Realizing cash flows through sale of the assets
- b. Assets are managed in order to realize their fair values
- c. Performance is measured on a fair value basis

³ IFRS9.B4.1.6

d. Portfolios that meet the definition of held for trading

IFRS 9 does not define a specific level at which the business model assessment should be performed. As a result the standard allows aggregation of assets into portfolios of similar assets. This assessment should be determined by key management personnel⁴. Some key factors that management can consider when make this assessment is as follows:

a. Objective of each portfolio

This reflects how groups of financial assets are managed together to achieve a particular business objective. This could be different even if assets are similar

b. How performance is evaluated and reported and how risk affecting performance of assets is managed

c. How managers of the business are compensated.

Compensation, performance and risk assessment may be based on fair value of assets managed or on contractual cash flows collected. This indicates whether investment managers are assessed based on a net asset value or a fair value basis.

It is possible that different assets though similar may be managed differently and this should be considered when assessing the business model. For instance, in a portfolio some instruments could be held with an objective to collect contractual cash flows only whilst others could be sold within the same portfolio. In this regard, the entity will have two different business models for that portfolio.

It is vital to note that if the assessment is done at the incorrect level the incorrect business model may then be used leading to a wrong classification of financial assets.

The impact of this is that seemingly similar assets may be classified differently due to different business models.

A summary table for classification is included in [Table 1.](#)

Equity instruments

The SPPI and business model test described above is only required for debt instruments. Entities would now need to consider whether they want to designate the instrument as at FVTPL or to irrevocably designate it as at FVTOCI.

This election can be made separately or on an instrument by instrument basis, for each equity instrument.

However amounts presented to OCI are not subsequently transferred/recycled to profit or loss but can only be transferred within equity.

IFRS 9 now requires that all equity instruments be measured at fair value and not cost.

⁴ IFRS 9.B.4.1.1 and IFRS 9.B.4.1.2

Where fair value cannot be reasonably determined IAS 39 allowed you to measure at cost however, IFRS 9 removed this cost exemption for unquoted equity instruments and derivatives on unquoted equities⁵.

The Standard provides guidance on limited circumstances when cost may be an appropriate estimate of fair value. This may be the case if

- a. insufficient more recent information is available to measure fair value, or
- b. if there is a wide range of possible fair value measurements and
- c. cost represents the best estimate of fair value with a range of possible fair values

It is important to note that IFRS 9 specifically scopes out investments in a subsidiary, and is instead accounted for under IAS 27 Separate financial statements.

II Classification of Financial liabilities

The Standards default categorisation for financial liabilities is amortised cost with exceptions for the following⁶:

- d. Financial liabilities measured at FVTPL
- e. Liabilities arising when a transfer of assets does not qualify for de-recognition or when there is continuing involvement in the transferred asset.
- f. Financial guarantee contracts. These are measured at the higher of the amount provided using guidance in IAS 37 Provisions, Contingent Liabilities and Contingent Assets and the amount on initial recognition less cumulative amortisation.
- g. Commitments to provide a loan at a below-market interest rate
- h. Contingent consideration recognized by an acquirer in business combination to which IFRS 3 applies

At initial recognition entities also have an irrevocable option to designate a financial liability as at FVTPL⁷. This is possible when doing so is allowed by P4.3.5 and to eliminate a measurement inconsistency/accounting mismatch or when the liabilities is managed on a fair value model.

Reclassification

The Standard allows for the reclassification of certain financial instruments. Financial asset can be reclassified ***however financial liabilities cannot be reclassified***⁸.

Reclassification occurs when there is a change in the entity's objective for managing the instruments. However IFRS 9 gives specific circumstances which are not considered as a change in the business model:

- a. a change in intention related to particular financial assets, even in circumstances of significant changes in market conditions;

⁵ IFRS 9 P5.2.3

⁶ IFRS 9.4.2.1

⁷ IFRS 9.4.2.2

⁸ IFRS 9.4.4.2

- b. a temporary disappearance of a particular market for financial assets; or
- c. a transfer of financial assets between parts of the entity with different business models.

As a general principle, a change in the objective of the entity's business model must be effected before the classification date.

Summary

In Summary it is important to decide whether a financial asset is debt or equity. This is the same as previous requirement of IAS 39.

When a debt instrument has been identified there are two other tests applied namely the SPPI test and the business model test.

It is important to be note the appropriate business level when performing an assessment

Equity instruments can be designated as being at FVTPL or irrevocably designated as at FVTOCI. However cost can no longer be used as an alternative to Fair value except in unique circumstances⁹.

⁹ IFRS 9.B5.2.3-4

Table 1: Summary table for Classification and Measurement of Financial Assets

<i>Business Model</i>	<i>Statement of Financial Position</i>			<i>Statement of Comprehensive Income</i>
<i>Held to Collect</i>	Category Amortized Cost	Initial Fair value plus or minus transaction costs	Subsequent Amortized Cost	Presented in P&L: a) interest calculated using the effective interest method b) initial impairment allowance and subsequent changes c) on de-recognition, gains and losses recognized in P&L
<i>Hold to collect & Sale</i>	FVOCI	Fair value plus or minus transaction costs	Fair Value	<ul style="list-style-type: none"> • Changes in fair value presented in OCI • Presented in P&L: d) interest calculated using the effective interest method e) initial impairment allowance and subsequent changes (with offsetting entry presented in OCI) f) foreign exchange gains and losses • Cumulative FV gains/losses reclassified to P&L on derecognition or reclassification
<i>Other Business Models</i>	FVTPL	Fair value	Fair Value	<ul style="list-style-type: none"> • Changes in fair value recognised in P&L
<i>Equity Instruments</i>	FVTOCI	Fair value plus or minus transaction costs	Fair Value	<ul style="list-style-type: none"> • No reclassification to P&L on disposal • Changes in fair value presented in OCI • Dividends generally recognised in P&L

Introduction to impairment

IFRS 9 introduces a new impairment model that is different from previous guidance in IAS 39. It introduces an expected credit loss (ECL) model as opposed to the “incurred loss” model.

The main difference between the two models is that the expected loss model uses forward looking information¹⁰.

The standards also introduces a 3 stage impairment model which will result in losses on initial recognition of financial assets.

Objective evidence that financial assets are impaired includes:

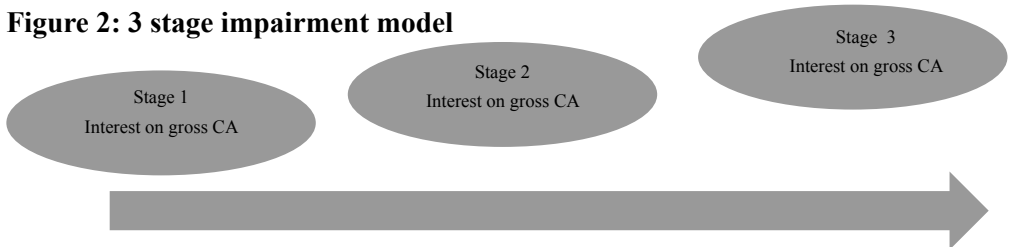
1. default or delinquency by a debtor,
2. restructuring of an amount due to the company on terms that the company would not consider otherwise,
3. indications that a debtor or issuer will enter bankruptcy,
4. adverse changes in the payment status of borrowers or issuers,
5. economic conditions that correlate with defaults or
6. the disappearance of an active market for a security.
7. for an investment in an equity security, a significant or prolonged decline in its fair value below its cost.

¹⁰The source of such information may be periodical issues from the Reserve Bank of Malawi, National Statistical Office, industry related publications, and political analyses.

Impairment model

IFRS 9 introduces the ECL model which has different stages of impairment of a financial instrument. The model's different stages of impairment are dependent on the circumstances of the receivable.

Figure 2: 3 stage impairment model



Stage 1

Assets with no significant increase in credit risk at the reporting date/period end fall into stage 1. This stage requires that the expected loss be considered

- a) for a period of 12 months and
- b) Interest revenue is recognized on the gross carrying amount of the asset.

The expected loss is not the expected cash shortfall alone but the cash shortfall after considering the probability of the loss occurring.

Stage 2.

Assets which have had a significant increase in credit risk but are not yet evidently or objectively impaired are included in this stage. This stage requires that the expected loss be considered

- a) Over the asset's life time and
- b) Interest revenue is recognized on the gross carrying amount of the asset.

The expected loss is not only the expected cash shortfall but the cash shortfall after considering the probability of the loss occurring and also from all possible default events over the expected life of the financial instrument.

Stage 3

Assets which have had a significant increase in credit risk are evidently or objectively impaired are included in this stage. This stage requires that the expected loss be considered

- a) Over the asset's life time and
- b) Interest revenue is recognized on the net carrying amount of the asset.

Improvement in the credit/market risk

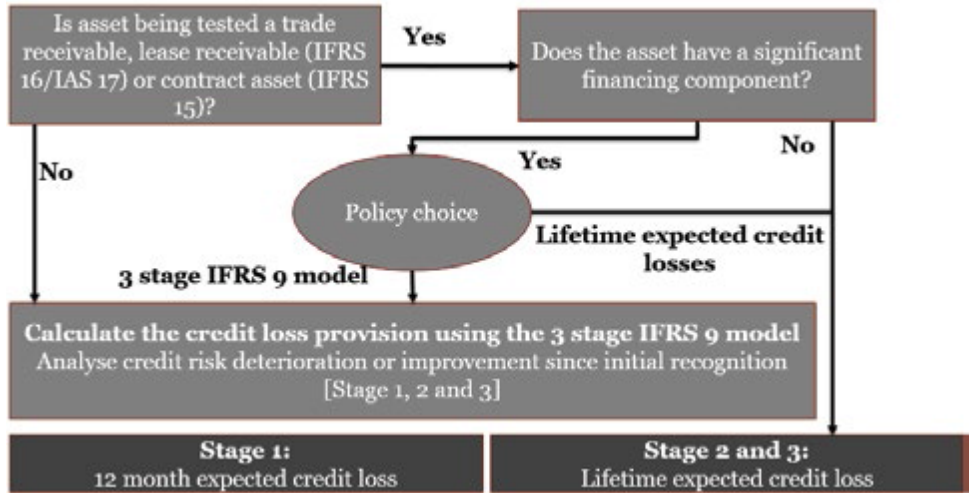
The standard says that there is need of monitoring the impairment factors on a continuous basis. Assets may be impaired based on impairment factors, and may either deteriorate or improve and move to another stage.

Significant increase in credit risk (SICR)

IFRS 9 gives the following indicators of a SICR:

- a) A financial asset that shows evidence of impairment on initial recognition such as when it is acquired at a deep discount
- b) A breach of contract such as a default or a past due event
- c) Financial difficulty to parties to the contract
- d) Granting of significant concessions to the borrower which a lender would not normally provide

Figure 3: Impairment methodology



Firstly the standard requires that entities consider whether the asset under consideration is a trade receivable, lease receivable or contract asset? If not one of these, the full IFRS 9 model will need to be applied¹¹.

The second consideration is whether the asset contains a significant financing component or not.

- The standard requires that if there is no significant financing component all such assets should be accounted for using stage 2 calculation so that the loss allowance is measured on initial recognition and throughout the life of the asset at an amount that is equal to lifetime ECL. The standard allows for a provisioning matrix to be used for this purpose.
- If there is a significant financing component, such as receivables and contract assets as per IFRS 15, entities have a policy choice as follows¹² :
 - o Simply account for the lifetime ECL or
 - o Use the full IFRS 9 model where increases in credit risk would need to be monitored.

Thirdly forward looking information should be taken into account both in determining if there is a SICR if the full model is used and in calculating the ECL¹³.

¹¹ IFRS 9 .5.5.5

¹² IFRS 9.5.5.15a(ii)

¹³ IFRS 9.5.5.17

Lastly, it is possible that some receivables and financial assets may have already been discounted to account for the time value for money but an additional provision would need to be done to account for credit risk as a separate provision.

Provision Matrices

As indicated before, IFRS 9 introduces a change from the traditional provisioning approach based solely on historical information to one that is forward looking. Historical information led to the use of standard default rates applied to various time buckets of ageing. This approach is no longer acceptable.

A provisioning matrix, for receivables as an example, may be prepared as follows:
The starting point is to “learn from the past” and calculate the payment profile of the receivables from a chosen period and how much was written off as bad debts.

This involves calculating how much of the receivables are outstanding after each period/time bucket up to the point where related bad debts are eventually written off:

		Cumulative payment	Outstanding debtors ageing	ABC Ltd provision policy	
	K'000	K'000	K'000		Comment
Sales (K)	20, 000				
Paid in 30 days	(4,000)	(4,000)	16,000	3%	
Paid between 30 to 60 days	(7,000)	(11,000)	9,000	3%	
Paid between 60 to 90 days	(6,000)	(17,000)	3,000	4%	
Paid after 90 days	(2,400)	(19,400)	600	8%	written off

In the example above customers paid K 4m, K 7m, K6m and K2,4m within 30 days, 60 days, 90 days and over 90 days respectively, resulting in a debtors ageing profile of K 16m, K9m, K3m, until ultimately the remaining receivables of K 600,000 were written off.

With this information the default rate can be calculated for each time bucket based on a comparison of the final amount written off to the outstanding debtors of each time bucket as follows:

		cumulative payment	Outstanding debtors ageing	Loss	Default rate
	K'000	K'000	K'000	K'000	
Sales (K)	20,000			600	3.00%
Paid in 30 days	(4,000)	(4,000)	16,000	600	3.75%
Paid between 30 to 60 days	(7,000)	(11,000)	9,000	600	6.67%
Paid between 60 to 90 days	(6,000)	(17,000)	3,000	600	20.00%
Paid after 90 days	(2,400)	(19,400)	600	written off	

The default rate for the total sales made is K600,000/K20m resulting in a provision of 3%, 3.75%, 6.67% and 20% for current sales and respectively for the subsequent time buckets.

The historical default rates have now been calculated for the various time buckets and it can be noted from this that the default rate for each period is quite different from the standard provision policy of ABC Limited.

Since IFRS 9 is a forward looking or “expected loss” model, the next step is to incorporate forward looking information. In order to do this we will assume the following economic developments and indicators:

- It is assumed that there would be an economic downturn leading to higher unemployment
- The payment profile/debtors ageing is the same as discussed earlier

As a result of the above the expected loss is adjusted to K800,000. Other types of forward looking information that can be considered can include but are not limited to; the economic, regulatory, technological and industry outlooks, external market indicators and behavior of the customer base.

Using this adjustment the default rates are recalculated as follows:

		Cumulative payment	Outstanding debtors ageing	Expected Loss	Default rate
	K'000	K'000	K'000	K'000	
Sales (K)	20,000			800	4.00%
Paid in 30 days	(4,000)	(4,000)	16,000	800	5.00%
Paid between 30 to 60 days	(7,000)	(11,000)	9,000	800	8.89%
Paid between 60 to 90 days	(6,000)	(17,000)	3,000	800	26.67%
Paid after 90 days	(2,400)	(19,400)	600	written off	

After studying a period from the past as has been illustrated above the next step is to apply these rates to the ageing profile at the reporting date. Assuming ABC Limited had debtors of K56.5m the provision would be as shown below:

	Outstanding debtors ageing	Expected loss default rate	Provision
	K'000		K'000
current (0-30 days)	24,000	4.00%	960
30 - 60 days old	19,000	5.00%	950
60 - 90 days old	7,500	8.89%	667
over 90 days old	6,000	26.67%	1,600
Total	56,500		4,177

The impact of applying this IFRS 9 is shown when compared with ABC Ltd's provision policy as follows:

	Outstanding debtors ageing	Expected loss default rate	Provision	ABC Ltd provision rates	Provision	Difference
	K'000		K'000			
current (0-30 days)	24,000	4.00%	960	0.00%	-	960
30 - 60 days old	19,000	5.00%	950	3.00%	570	380
60 - 90 days old	7,500	8.89%	667	4.00%	300	367
over 90 days old	6,000	26.67%	1,600	8.00%	480	1,120
Total	56,500		4,177		1,350	2,827

IFRS 9 results in a higher provision of K4.18m instead of K1.35m based on ABC Ltds provisioning policy.

Summary methodology

In summary the provisioning matrix methodology is as follows

Step 1: Define a period of sales and calculate how many of those sales were written off as bad debts.

Step 2: Calculate the payment profile for the receivables.

Step 3: Calculate the historical default rate as a percentage of each time bucket.

Step 4: consider forward looking information.

Step 5: apply the adjusted default rate to the reporting date ageing profile.

It is important to note that IFRS 9 does not prescribe a specific provisioning matrix format and this is only one method that may be used. Other acceptable methods could be used if they are based on the principles of the standard¹⁴.

Impairment of assets that are not trade receivables (using 12 month and lifetime credit losses).

In cases where the financial assets being assessed for impairment are not trade receivables, the provisioning matrix illustrated above may not be appropriate.

¹⁴ Basel ii could be taken as an example of 'other acceptable methods'

The provisioning formula is as follows:

“Exposure in case of default X extent of loss X Probability that default will occur”

A: 12 month expected credit losses

The example below gives a scenario whereby there is no SICR and the 3 stage IFRS 9 model is used. Because there is no SICR in the next 12 months a stage 1 or 12 month ECL is calculated as follows:

Value of contract asset with a significant financing component of K4m

The financing period is 24 months (discounting has been ignored for purposes of this illustration)

K400,000 has been paid in the first quarter and the exposure is K3.6m

In case of default (failure to pay) the loss that would be incurred is estimated to be 55% of the carrying amount.

The probability of this happening in the next 12 months is 5%

The provision is therefore as follows:

“Exposure in case of default -(K3.6m) X extent of loss (-55%) X Probability that default will occur -(5%)” = K99,000

B: Lifetime expected credit losses

In year 2 the scenario above has progressed as follows:

Value of contract asset with a significant financing component of K4m

The financing period is 24 months (discounting has been ignored for purposes of this illustration)

K2.1 m has been paid in the first year and the exposure is now K1.9m

In case of default (failure to pay) the loss that would be incurred as a write off is estimated to be 55% of the carrying amount.

The marginal probability of this happening in the last 12 months is 8%. Note that marginal probability is the possibility of the default happening in year 2 if it has not taken place in year 1.

Applying the provisioning formula the provision for the 13 to 24 month period is as follows:

“Exposure in case of default-K1.9m X extent of loss -(55%) X Probability that default (PD) will occur -(8%)” = K83,600

The total lifetime credit loss is therefore as follows

$$K99,000 + K83,600 = K182,600$$

The two provisions have been added because the calculation has taken into consideration that a loss may either happen in 0 -12 months and that the marginal PD takes into account that the default may be take place in 13 – 24 months.

This illustration shows that lifetime ECL's are expected to be much higher than 12 month ECL's however in companies can use only one calculation for purposes of expediency.

4. Tax implications of IFRS 9

The tax implications of IFRS 9 also deserve discussion as the new standard is applied. To begin with it must be emphasized that the taxation principles remain unchanged however the tax implications arising from application of the new standard are expected to be significant.

Introduction

The key taxation principles relate to whether costs are allowable or disallowable. The costs in question as far as IFRS 9 is concerned are provisions and impairments of financial assets.

There are two further principles that determine this namely

- 1- Whether gains and losses are realized or unrealized and
- 2- Whether provisions are general or specific.

Realised and unrealized gains and losses

Section 28 of the tax act requires that only realized gains and losses be included in taxable income.

The fair valuation of financial assets will result in unrealized gains and losses until the assets are sold. As a result all unrealized gains are not taxable and have to be excluded or deducted from accounting profits to arrive at taxable income (or “income for tax purposes”). Similarly unrealized losses are not true or recognized losses for tax purposes and have to be added back to accounting profits to arrive at true losses for taxation purposes.

Profitability and current income tax impact

IFRS 9 uses an expected loss approach for provisioning meaning that it is a more prudent model which makes provision both earlier and at higher amounts. This will impact reported “accounting” profits which are expected to be much lower (than in the previous IAS 39 model) while taxable income effectively remains unaffected by the “quantum” of the disallowed unrealized or general provisions.

The taxable income will therefore be much higher than accounting profit (to-the extent of the disallowed unrealized movements and general provisions as will be the related tax charge).

This has the potential of affecting the opinion of users of the financial statements as in the example shown below.

Scenario	1	2		Ref
	Provision	Provision	Difference	
	Per IAS 39	Per IFRS 9		
	K,000	K,000	K,000	
Profit before provisions	100,000	100,000		
Provisions	(1,350)	(4,177)	2,827	
	98,650	95,823	2,827	
Admin costs	-(6000)	-(6000)		
Accounting profit before tax	92,650	89,823	2,827	1
Tax computation				
Accounting profit before tax	92,650	89,823	2,827	
Add back				
General provision	1,350	4,177	(2,827)	
Taxable income	94,000	94,000	0	
30%	28,200	28,200		
* Deferred tax asset on first year addbacks	405	1,253	-(848)	

* Being 30% of the general provision add back assuming it is the first year of accrual.

Deferred tax impact of the above.

The deferred taxation principles also remain unchanged. The fair value gains and losses will result in timing differences which will have a future taxation impact when financial assets are eventually recovered or disposed of. As a result an unrealized gain is a potential tax liability while an unrealized loss is a potential tax deduction to future profits. The effect of allowing or disallowing a fair value movement (gain or loss) for income tax purposes will effectively have an equal and opposite impact for deferred tax purposes.

Therefore while for income tax items are added back and deducted they are expected to result in related deferred tax liabilities and assets respectively. While the quantum of the movements is expected to increase the net movement in any year of assessment is expected to exactly compensate or be self-cancelling as a result the total tax rate should still remain close to the legislated rate of 30%¹⁵ except for permanent differences which may slightly increase or decrease the effective total tax rate. The quantum of deferred tax assets and liabilities however is expected to increase as illustrated in the example above whereby deferred tax assets increased by K848,000.

Recognition of tax charges

IAS 12: *Income Taxes* indicate in paragraphs 58 and 61 how tax charges are recognized as either being in profit or loss or in equity. This principle also remains unchanged as IFRS 9 is applied, however, the application of the standard means that items that were previously recognized in equity may now be recognized in profit or loss and those that were

¹⁵ or 35% for branches of foreign incorporated companies

recognized in profit or loss may now be recognized in equity depending on the new classification model. This is because the tax charge follows the nature of the taxable item. If it is an item in profit or loss then it will be recognized in profit or loss. If in equity, then in equity and so on.

General and specific provisions

The taxation act in sections 45 (e) and 36 (1) gives guidance on how provisions are treated for tax purposes. The act requires that only specific provisions be allowed as deductible for tax purposes with the exception of provisions in the insurance business as specified in the Seventh Schedule of the Act.

In order to make the distinction we describe the two categories below:

General provisions

The following provisions qualify as general in nature:

- Stage 1 or day 1 impairment losses. In stage 1 a company estimates losses for the 12 month period without any loss actually being incurred.
- Stage 2 losses. In this stage provisions are also recognized without incurring actual losses as a result stage 1 and 2 losses should be disallowed for tax purposes as being a general or a notional provision only.
- Provisions made of a portfolio of assets especially using a general or a standard rate such as a percentage applied to a portfolio of assets or receivables.

Specific provisions

Specific provisions are those which relate to individual balances of assets that are deemed to be unrecoverable after all reasonable steps have been taken to recover it and must be considered as such by the Commissioner General.

Such provisions are allowable if the following criteria have been met:

- The amount exists in the books of the taxpayer in the current or previous years
- The asset or debtor is individually identifiable by name and other indicators.
- Adequate reasons why it is uncollected should be available to the satisfaction of the Commissioner including but not limited to bankruptcy, death and financial difficulty.
- Necessary steps must have already been taken to recover the asset

As a result of the above it is expected that stage 3 provisions have a higher likelihood of being considered as specific by the Malawi Revenue Authority. However not all stage 3 provisions may be specific especially if the provisions are based on provisioning systems which use blanket rates such as matrices as opposed to individual listings. However as a practical expedient tax payers need to engage the MRA to determine if they would deem this as a reasonable alternative to the laborious “balance by balance” provisions. This will be key for entities with numerous balances such as those experienced in the financial services sector.

5. Transition Provisions

When transitioning to IFRS 9 companies would need to identify the date of initial application which in this case is 1 January 2018.

Secondly companies should determine what the credit risk of their financial assets was at the date of their initial recognition (using reasonable and supportable information that is available without undue cost or effort)¹⁶.

Companies should then assess whether there has been a SICR of assets since initial recognition and for such asserts there should be recognition of lifetime ECLs.

If assets have a low credit risk on date of initial application this assessment it is assumed that they remain low risk with no SICR on the assessment date.

It is also assumed that all trade receivables that are more than 30 days old have had a SICR and lifetime ECLs ought to be use.

Entities are also allowed to use lifetime ECLs if there would be undue cost or effort of assessing credit risk on the application date.

Entities are required to apply IFRS 9 retrospectively but are not required to restate comparatives unless they can do so without the use of hindsight. As a result an adjustment is made to opening retained earnings.

6. Appendices

Appendix i- IFRS 9 – Financial instruments disclosures

Appendix ii- Examples of financial instruments on SPPI

¹⁶ IFRS 9.7.2.18

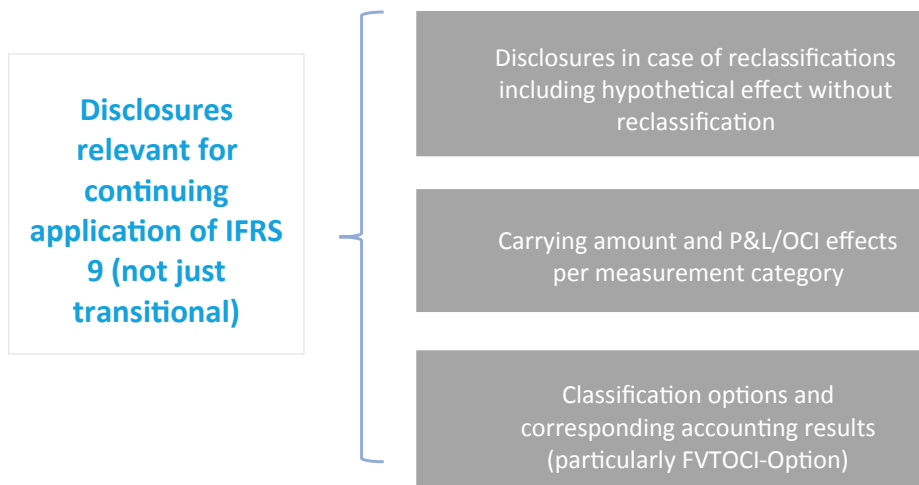
Appendix i. IFRS 9 – FINANCIAL INSTRUMENTS DISCLOSURES

IFRS 9 – *Financial Instruments “Recognition & Measurements”* itself does not cover Disclosures, you may re-call that IFRS 7 – *Financial Instruments “Disclosures”*, covers disclosures.

However this guidance shall give a glimpse of how disclosures will be done just like how we have included the tax implications.

Disclosures

Requirements in IFRS 7 are amended for the new classification and measurement model of IFRS 9;



Requirements in IFRS 7 for the credit risk assessment of IFRS 9;

The disclosures shall enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows

- 1 Credit risk management practices and their relation to the recognition and measurement of expected credit losses
- 2 Evaluation of the amounts in the financial statements arising from expected credit losses
- 3 An entity's credit risk profile including significant credit risk concentrations

How a 'significant increase in credit risk' is determined

How an entity determines financial instruments to have 'low credit risk'

If rebuttable presumption of >30 and >90 days past due has been rebutted, with reasons;

The definition of default selected, and reasons

How a financial asset being 'credit-impaired' is determined

Disclosure of the write-off policy adopted, and reasons

How changes in credit risk due to modifications are determined

How groupings for collective portfolios are determined

Disclosures are considerably more qualitative in nature.

Entities will need to formulate policies and procedures on the following:

2. Evaluation of the amounts in the financial statements arising from expected credit losses

Modifications

-Amortised cost before modification and net modification gain/loss during year (while in stage 2/3)

-Gross carrying amount at y/e of all modifications since initial recognition that moved from stage 2/3 to stage 1

Collateral (and other credit enhancements)

-Maximum exposure to credit risk excl. collateral

-Nature and quality

-Significant changes

Reconciliation of the loss allowance – refer example 1

Reconciliation in the gross carrying amount

Write-off

3 An entity's credit risk profile including significant credit risk concentrations



Example 1. Illustrating the application of the reconciliation of the loss allowance

Mortgage loans - loss allowance	Stage 1 12-month EL	Stage 2 (collectively assessed)	Stage 2 (individually assessed)	Stage 3
Loss allowance as at 01. January	X	X	X	X
Changes du to financial instruments recognised as at 01. January:				
- Transfer to stage 1	X	(X)	(X)	--
- Transfer to stage 2	(X)	X	X	--
- Transfer to stage 3	(X)	--	(X)	X
- Financial assets that have been derecognised during the period	(X)	(X)	(X)	(X)
New financial assets originated or purchased	X	--	--	--
Write-off	--	--	(X)	(X)
Changes in models/risk parameters	X	X	X	X
Foreign exchange and other movements	X	X	X	X
Loss allowance as at 31. December	X	X	X	X

Appendix ii. EXAMPLES OF FINANCIAL INSTRUMENTS

Some of the examples instruments cover by IFRS 9 are:

a) Short term debt (Treasury Bills & Commercial Paper)

These instruments were classified as available for sale or FVTPL under IAS 39 and do not pay explicit coupon instead the discount (i.e. difference between the par/face value and cost) is the interest. Most of the Treasury bills are likely to be issued by Malawi Government whose return usually represents consideration for time value of money for the credit risk associated with the principal amount outstanding consideration during a particular period of time and for other basic lending risk as well as a profit margin.

b) Bond

These are fixed income investments where an investor loans money to the issuer who has borrowed the funds for a specified period of time at a variable or fixed interest rate. Under IAS 39 bonds were classified as either FVTPL, available for sale or held to maturity category. These bonds have different features as such an entity should assess whether the contractual cash flows meet the SPPI assessment by considering the time value of money and the credit risk.

When a bond contract is extended the entity should determine whether the contractual cash flows that could arise over the life of the instrument meet the SPPI test. Bonds whose principal and interest do not take into account the basic lending arrangement will likely violate the SPPI criterion.

c) Letter of Credits

These are off balance sheet transactions. However, in the event that the LC is exercised then the arrangement is accounted for as a loan and an assessment should be made on whether the contractual cash flows meet the SPPI criterion.

d) Overdraft Facilities

The cash flows of these facilities are repayment of principal and interest as such they are likely to meet SPPI criterion. If the contractual cash flows are inconsistent with consideration of time value of money then, this will not meet the SPPI criterion. This will most likely be the case if interest is waived.

e) Derivatives

Since the value of derivatives changes in response to certain underlying variables, they do not have contractual cash flows which are solely payments of principal and interest. In this regard, they shall be classified and measured at FVTPL unless designated in a cash flow hedging relationship.

f) Promissory Notes

Promissory notes could be classified as available for sale, held to maturity, loan and receivable under IAS 39. Promissory notes on the market are usually based on the current policy rate and some are zero rated. These transaction should be assessed to check whether is consistent with basic lending arrangement.

g) Mortgages and Loans

Under IAS 39 these were classified as loan and receivables and recognized at amortized cost. However, the contractual cash flows of these transaction can be

amended due to loan refinancing and other regulatory policies. An entity should apply judgement to assess whether the changes of contractual cash flow for the loan are consistent with those of the basic lending arrangement.

h) **Equity Investment**

These investment fail the SPPI criterion and are measured at FVTPL subject to the option to designate such securities at FVOCI. These excludes investment where IFRS 3 applies.

Where financial assets such as a loan book is sold to another party the asset business model may be to hold and sell, or to purely speculate and sell without holding to maturity. Therefore the business model should be considered to determine the correct classification.

