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Technically Speaking
The Light of Knowledge

Accounting & Auditing
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Welcome

Dear colleagues

Welcome to our twenty first edition of Technically Speaking!

This edition includes articles on the following topics:

Highlights of the JSE Report- Reporting Back on Proactive Monitoring of Financial Statements in 2015
This article provides highlights critical issues and findings from the South African regulator on proactive monitoring of financial statements in 2015.

IFRS 9 Financial Instruments: Impact on Corporates – Things you need to know #1
This is a first of a series of thought pieces on IFRS 9 *Financial Instrument* and its impact on non-financial institutions. Our first article discusses the classification and measurement considerations of financial assets under this Standard.

Revenue – Things you need to know #3
This article is one of a series of articles to including topical issues in preparation IFRS 15 Revenue from Contracts from Customers. In this issue, we consider the impact of contract modifications on revenue recognition.

IRBA Updates: Impact of Auditors to Disclosure Tenure of Service in the Audit Report
We explore the IRBA's recent announcement for the requirement for auditors to disclosure tenure in their audit reports and its impact for both auditors, management and those charged with governance.

We look forward to your comments on this publication.

Kind regards

N. Ranchod

Nita Ranchod
Business Unit Leader
Accounting & Auditing

Highlights of the JSE Report – Reporting Back on Proactive Monitoring of Financial Statements in 2015

Article by:

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The Johannesburg Stock Exchange (JSE) has issued their report on proactive monitoring of financial statements in 2015. The JSE report highlights critical issues and findings from the South African regulator's perspective and is therefore an important document for South African companies with listed equity or debt instruments as well as for their auditors and advisors. This article provides a high-level summary of key article matters. The full JSE report can be retrieved from the JSE homepage.

JSE's Five-Year Cycle and Upcoming 2016 Review Cycle

JSE's objective is to cover every issuer at least once within a five-year cycle, with 2015 marking the end of the first cycle. In 2015, 64 annual financial statements (AFS) and interim results were reviewed by JSE. Seven cases resulted in restatements of the AFS and public announcements. For a further six cases, misstatements were such that JSE agreed with the issuer that it could be corrected within the next published results.

	2011	2012	2013	2014	2015
Letters of Query	40	68	59	67	52
Cases closed immediately	16	14	19	18	12
Number of AFS reviewed	56	82	78	85	64
Cases with Corrections	29	47	51	59	55

Looking forward, JSE highlights that a strong focus will continue on standards that are relatively new, specifically IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities* and IFRS 13 *Fair Value Measurement*.

Equity Securities Issuers – Reported Issues

JSE considers disclosure matters to remain a key area of non-compliance, specifically a lack of disclosures regarding significant judgements in terms of IAS 1 *Presentation of Financial Statements*, application of IFRS 12 *Disclosure of Interests in Other Entities* and IFRS 13 *Fair Value Measurement*. This does not only refer to lack of disclosures, but also providing excessive or confusing disclosures in financial statements.

The majority of issues with IFRS 12 *Disclosure of Interests in Other Entities* revolved around poor application of the requirements to disclose significant judgements exercised leading to the accounting treatment in a group situation. Examples are accounting for investments as associates despite various indicators of potential control, accounting for an 8% investment as an associate, consolidating an entity where less than half of the voting rights are held, unconsolidated structured entities and more.

The main area of concern related to IFRS 13 *Fair Value Measurement* relates to the omission of detailed Level 3 disclosures for assets and liabilities. JSE stresses that given that Level 3 is the lowest ranking in the fair value hierarchy, adherence to the disclosure requirements is arguably even more important than for other hierarchy levels. The types of information found lacking include use of valuation techniques, inputs, sensitivity analysis and actual amounts of gains/losses included in profit or loss.

Also interim financial statements and related disclosures are considered key issues. In particular, JSE points out that IAS 34 *Interim Financial Reporting* requires certain disclosures for financial instruments, even if there has been no change to the value.

The JSE further highlights incidents in which correction of a material error in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* has not been transparently presented and disclosed.

Highlights of the JSE Report – Reporting Back on Proactive Monitoring of Financial Statements in 2015

Other matters and examples addressed in JSE's report which we want to bring to your attention comprise

- Statement of Cash Flows in which non-cash items such as imputed interest were reflected as cash flows;
- Income taxes, in particular insufficient disclosures of the nature of permanent differences;
- Financial Instruments, for example linked units in Property Entities which recognised the debenture portion of linked units at a nominal value, instead of fair value as expected by the JSE;
- Impairment of Assets;
- Related Party Transactions;
- Share-based Payments.

Debt Securities Issuers – Reported Issues

As a pilot, the JSE has also put a sample of AFS for issuers of debt securities through its monitoring process. Approximately a third of these issuers are structured entities.

The JSE is pleased to note that 60% of the sample returned with a clean review, but highlights the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* as an area for consideration, especially for structured entities. Given the significance of net advances in securitisation vehicles, JSE expects to see extensive credit quality disclosures.

IFRS 9 Financial Instruments: Impact on Corporates – Things you need to know #1

Classification and measurement of financial assets

Article by:

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Introduction

2018 will be a challenging year for entities applying International Financial Reporting Standards (IFRS): not only will the new standard on revenue (IFRS 15 – *Revenue from Contracts with Customers*) have an impact on all companies, but accounting for financial instruments will undergo a fundamental change as well.

While banks and insurance companies in many cases have already started to analyse the impact of IFRS 9 on their business and their financial statements, corporates may underestimate the potential effect that this new standard can have on their financial reporting. Based on an assumption that corporates often only have 'simple' financial instruments on their balance sheets, important assessments regarding the impact of IFRS 9 on financial assets, liabilities, impairment considerations and – where applicable – hedge accounting might not get the necessary attention before the date of initial application. Management's focus might (understandably) be on the corporate's operations and the respective impact of IFRS 15, rather than financial instruments.

This article is the first part of a series of insights providing our views on what IFRS-reporting corporates will need to focus on when preparing for the implementation of IFRS 9. The focus on corporates allows for a more tailored and in-depth discussion of instruments that are relevant for these preparers. The series will cover topics such as classification & measurement of financial assets (this edition), financial liabilities (next edition), impairment, hedge accounting, disclosures and comparatives (future editions). The emphasis is clearly put on commonly used financial instruments that are considered relevant for the vast majority of corporates. Corporates in the context of this series refers to providers of goods and (non-financial) services as opposed to banks and insurance companies, which are typically understood as financial institutions.

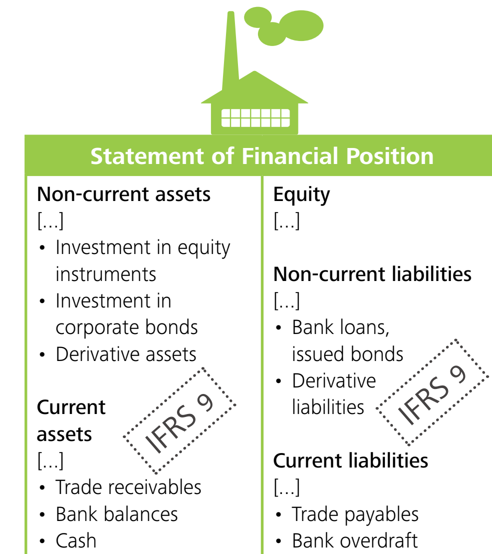
Which Financial Instruments will be affected by IFRS 9, and why is this relevant for Corporates?

A typical balance sheet of a corporation might comprise some or all of the following items: on the asset side, the company might have cash, bank balances, trade receivables and simple debt and equity instruments, such as investments in government or corporate bonds and shares in other entities.

On the liability side, the most significant items might be trade payables, short term financing through bank overdraft, and long-term financing through bank loans or issued bonds. In addition, certain corporates might use more complex instruments (derivatives) to hedge their risk exposures related to sales, purchases or financing.

Which of these commonly used instruments will be within the scope of IFRS 9? The answer is shown in the illustration of a corporate's simplified balance sheet below: potentially all of these instruments. For equity investments, IFRS 9 would be applicable only if the investment is not an associate, joint arrangement or subsidiary.

Does this mean that the recognition, classification and measurement principles will be completely different from IAS 39 when implementing IFRS 9? Not necessarily. The following sections will discuss the thought process that needs to be applied when determining the appropriate classification and measurement approach for financial assets. The corresponding discussion on financial liabilities will be presented in the next edition of *Technically Speaking.*



IFRS 9 Financial Instruments: Impact on Corporates – Things you need to know #1

Which new Categories will IFRS 9 introduce for Financial Assets and what needs to be assessed?

The current standard IAS 39 requires financial assets to be classified into one of the following categories:

- Fair Value through Profit or Loss (FVTPL - if held for trading, designated or derivative)
- Held to Maturity (HTM - fixed or determinable payments and maturity, intention to hold, not L&R)
- Loans & Receivables (L&R - fixed or determinable payments and maturity, not quoted)
- Available for Sale (AFS - residual category or if designated)

These categories will disappear and will be replaced by new categories in IFRS 9:

- At fair value through profit or loss (FVTPL)
- At fair value through other comprehensive income (FVOCI)
- At amortised cost (AC)

How to get from IAS 39 to the new IFRS 9 Categories

It is important to note that IFRS 9 does not provide a short-cut or an automatic, predetermined transfer from an existing category under IAS 39 to a new IFRS 9 category. This means that management need to assess all financial assets against the new requirements in IFRS 9 in order to determine the appropriate classification. This is done by applying the following two tests: the Business Model Test and the Contractual Cash Flow Characteristics (CCC) Test.

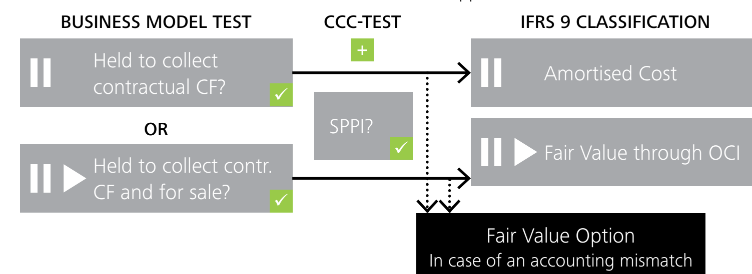
The Business Model and CCC Tests – why are two separate Tests required and how does it work?

The starting point in IFRS 9 for classification of financial assets is that neither the nature of the asset or management's intention on how to manage the asset is – by itself – necessarily sufficient to determine the appropriate classification. The standard requires companies to investigate the following:

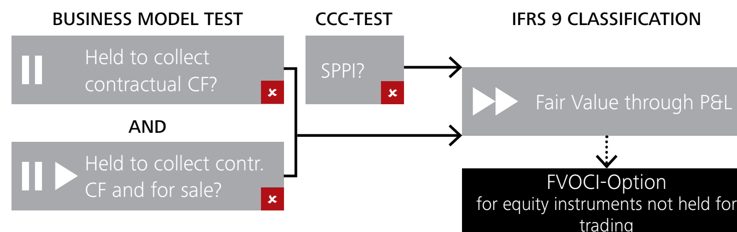
- What is management's intention regarding the asset? This is referred to as the Business Model Test. A financial asset may be acquired or originated in order to hold the instrument until maturity and collect contractual cash flows. Alternatively, the company may determine to both sell and hold instruments within a portfolio of financial assets. The latter might be the appropriate business model for a treasury department that bases its sell-or-hold decisions on the cash requirements of the corporate's operations. Finally, the business model may be to actively trade in financial instruments. Such a model would be more typical for a financial institution (trading desk), rather than for a corporation.
- What are the characteristics of the instrument? This test does not take management's intention into account, but focusses purely on the nature of the instrument itself. The key question to ask is whether the instrument consists **s**olely of **p**ayments of **p**rincipal and **i**nterest (also referred to as the 'SPPI' test). When considering the interest element, it is important to note that interest may only consist of time value of money, credit risk and other basis lending risks such as administrative costs. Interest which is linked to e.g. an equity or commodity index or to the borrower's earnings, will usually not meet this criterion, meaning that the instrument will fail the SPPI test.

The outcome of these two tests determines the appropriate classification in terms of IFRS 9: the three basic categories for financial assets are financial assets at amortised cost (AC), financial assets at fair value through other comprehensive income (FVOCI) and financial assets at fair value through profit or loss (FVTPL). The decision process is illustrated below, followed by a more detailed explanation and examples.

IFRS 9 Classification if one of the two business models is applied and the asset meets the SPPI test



IFRS 9 Classification if neither of the two business models is applied and/or the asset fails the SPPI test



Amortised Cost – an important Category for Trade Receivables

In order to achieve a classification as an AC instrument, the instrument needs to pass both the business model test "Held to collect" and the CCC test. AC means that interest is recognised in the income statement by using the effective interest method (which is the same calculation as under IAS 39) and that the instrument is subject to the (new) impairment requirements in terms of IFRS 9.

AC will be an important category for corporates since trade receivables will typically be held to collect the contractual cash flows (i.e. the payments from customers) and these receivables typically only represent the principal (amount outstanding) and interest, if receivables contain a financing element.

On the other hand, trade receivables that are subject to a factoring arrangement will probably fail the business model test "held to collect" and will therefore not qualify for AC measurement. This means that AC measurement basically requires a business model for which sales are not an integral part, with certain practical exemptions that are not discussed further in this article.

Fair Value through Other Comprehensive Income – relevant for Corporates' Treasury Departments

If the Business Model is to both collect contractual cash flows and sell financial assets, FVOCI might be the appropriate category in terms of IFRS 9. This requires, however, for AC instruments, that the CCC test is also passed. FVOCI for such instruments means that interest is calculated based on the effective interest method (as for AC assets), but that all other fair value changes that are not caused by effective interest, impairment or foreign exchange gains/losses are recognised in OCI.

Meeting both the Business Model Test and the CCC Test might be the case for a liquidity portfolio that is managed by treasury for the purpose of providing sufficient cash at any point in time. Note, however, that if the liquidity portfolio also comprises e.g. investments in equity instruments such as shares, convertible instruments or debt instruments for which interest is linked to e.g. equity or commodity indexes, the FVOCI classification for the portfolio would not be appropriate due to failing the CCC test. Such instruments are discussed below.

Fair Value through Profit or Loss – the default classification for "anything else"

If financial assets do not pass the CCC test, the instruments cannot be classified at AC or FVOCI. For corporates, the most relevant type of financial assets which will typically not consist of solely payments of principal and interest will be equity investments, e.g. shares in other companies. When classifying such an instrument (provided that the investment is not an associate, joint arrangement or subsidiary), the company does not need to assess the business model, because failing the SPPI criterion is already sufficient to conclude that AC and FVOCI will not be appropriate. Hence, the default category for such instruments will be FVTPL, meaning that the instrument is measured at fair value and all changes, including dividends, foreign exchange gains/losses and fair value gains/losses, are recognised in the income statement.

Another instrument for which this classification might be relevant are derivatives, either on a stand-alone basis (e.g. options, forwards or swaps)

or embedded in a host contract (e.g. conversion option of a convertible bond). While the fair value requirements for stand-alone derivatives will not change compared to IAS 39 (i.e. derivatives will need to be accounted for at FVTPL unless hedge accounting is applied), IFRS 9 introduces new accounting requirements for embedded derivatives on the asset-side: such derivatives may no longer be separated from the host contract, but the whole hybrid contract (meaning both the host and the derivative) will be measured at FVTPL. The treatment of (embedded) derivatives on the liability-side and derivatives in the context of hedge accounting will be discussed in the next editions of *Technically Speaking*.

It gets a little more complicated: Fair Value Option and Fair Value through OCI Option

So far, the classification of financial assets under IFRS 9 is relatively straight-forward, once the concept of the Business Model and CCC Test is understood. In addition to the AC, FVOCI and FVTPL categories discussed above, IFRS 9 introduces two further options that may be applied in certain circumstances and that will impact the classification and measurement of financial assets:

For instruments that pass the CCC test and meet one of the two Business Models 'held to collect' or 'held to collect and sell', companies may choose to designate the instrument at FVTPL, instead of AC or FVOCI. The requirement for such a designation is the presence of an accounting mismatch between financial assets and liabilities; a concept which is already applied under IAS 39. The consequence is that all fair value changes are recognised in the income statement.

Another option relates to instruments that fail the CCC test and are therefore to be measured at FVTPL: if these instruments are investments in equity instruments that are not held for trading (e.g. shares held as a strategic investment), the company may choose to designate these instruments at FVOCI at initial recognition. This means that fair value changes are recognised in OCI (instead of the income statement) and that these changes are not recognised ('recycled') in the income statement at a later point either, e.g. when selling the shares.

Summary

IFRS 9 introduces new categories for financial assets and requires all companies to assess their financial instruments based on the two-test-approach that has been presented in this article. For many corporates, this might be a rather simple exercise for certain instruments, such as trade receivables that are purely held to collect the cash flows from customers. For other instruments, such as equity investments, (embedded) derivatives, trade receivables in factoring arrangements and business models which are not purely held to collect contractual cash flows, the assessment might become more complex.

The key message this article intended to communicate is that corporate management are well advised to identify more complex financial assets, the company's applicable business models and areas of judgement well before 2018 as IFRS 9 will impact all IFRS-reporting entities in 2018, not just financial institutions.

IFRS 15 Revenue from Contracts with Customers – Things you need to know #3

Article by:

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Revenue is an important number in your financial statements and is used by many of your stakeholders. The new standard (IFRS 15 *Revenue from contracts with customers*) introduces a single revenue recognition model that will apply to all contracts with customers including the supply of goods and services. In adopting the new standard you may come across some areas that are topical to your business. In this and the forthcoming issues of Technically Speaking we will discuss the things you need to know about the new revenue standard and how these may impact you.

Contract modifications

The standard provides new guidance on accounting for modifications to contracts with a customer. This accounting for contract modifications differs from the existing revenue standard that allowed entities to recognise revenue for variations if it was probable that the variation would be approved. Revenue amounts reported under IAS 18 are therefore higher in earlier years due to the lower threshold for contract modification revenue. Under IFRS 15 modification revenue will be recognised later when the modification is approved by both parties to the contract. The total amount of revenue recognised over the contract is therefore the same, but the timing of revenue recognition is delayed under IFRS 15. Consequently, you may need to evaluate contract modifications to determine the appropriate manner in which to recognise the related revenue.

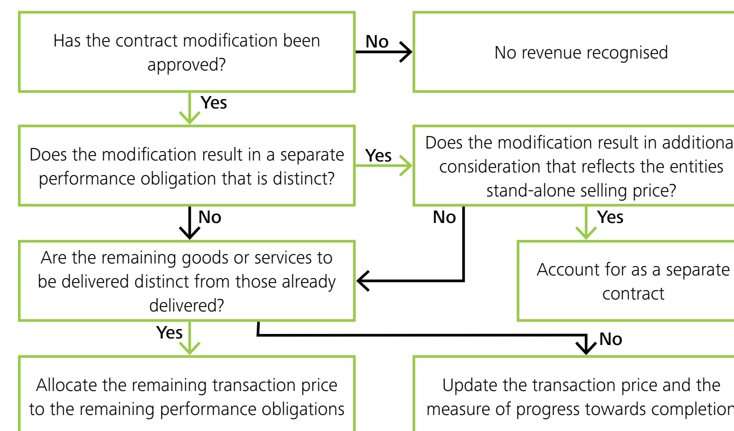
The transitional provisions of the new revenue standard do not provide relief for any modifications that have not been approved but for which revenue has been recognised. This means that all modifications that are currently recognised, which have not yet been approved, would be derecognised under the new standard. This has a potentially large impact if your entity is in the construction industry and has large contract modifications that have not yet been approved on adoption of the new standard.

Example

You are building an office block for Customer A. You and Customer A have a contract for you to build the office block and hence you may recognise revenue. Whilst building the office block you notice that the main water pipe needs to be moved from its original location. This move was not anticipated in the original plan or contract with Customer A. You think it is probable that Customer A will pay for the water main to be moved, although the amount payable may vary based on your discussions with her.

Under IAS 18 Revenue you can recognised the revenue from the contract modification prior to Customer A agreeing to you moving the water main, as you think it is probable that she agree to this. Under IFRS 15 you can only recognise the revenue for moving the water main after Customer A has agreed to the contract modification.

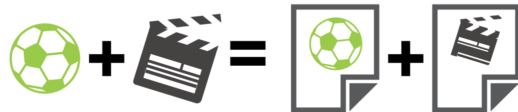
The new standard may also change the timing of revenue recognition based on whether modifications are treated as a new contract or a modification of the existing contract. You can use the diagram below provides for guidance on how to account for contract modifications as either a new contract or a modification to an existing contract:



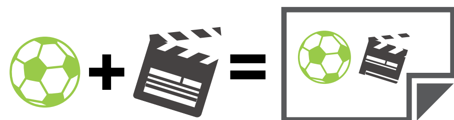
IFRS 15 Revenue from Contracts with Customers – Things you need to know #4

Example A

Customer B has a one year entertainment viewing bundle with you which allows him to view all of the sport channels that you offer. During his one year contract Customer B chooses to add movie channels to his bundle. You charge Customer B the standalone selling price of the movie channels (he does not obtain a discount for already having an existing bundle with you).



As you charge Customer B the same standalone selling price of the movie channel, the contract for the movie channel and the sports channel are treated as separate contracts. Each contract is treated separately for revenue recognition purposes.



Let's assume you do give customer B a discount for the fact that he has the sports package with you. Then the existing sports contract is modified and a new sports and movie contract exists. Revenue for this combined contract is based on the new combined price and the new performance obligations of delivering both the sports and movie channels.

IRBA Updates: Impact of Auditors to Disclosure Tenure of Service in the Audit Report

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The disclosure of audit tenure

The Independent Regulatory Board for Auditors (IRBA) published a Rule in the Government Gazette (Nr 39475 of 04 December 2015) which makes it mandatory that all auditor's reports on Annual Financial Statements of all public interest entities shall disclose the number of years which the audit firm has been the auditor of the entity (audit tenure).

This rule by the IRBA applies to audit reports issued on the annual financial statements of all public interest entities, as defined in the Companies Act of 2008 (public and state-owned) and prescribed by the IRBA from time to time, for periods ending on or after 31 December 2015. All December year-end audit reports of listed and other public interest entities should thus comply with this requirement.

Landscape of independence in South Africa

In addition to the International Federation of Accountants (IFAC) ethical codes that governs appropriate independence of auditors, the South African Companies Act (Act) has three critical requirements. The first is in the form of mandatory audit partner rotation every five years to mitigate the familiarity threat to independence of the individual (Section 92). Secondly, the Act prohibits the appointment of a person or firm as an auditor who is a director, prescribed officer, employee involved in maintenance of financial records, who habitually or regularly performs the duties of accountant or bookkeeper, or performs related secretarial work, for the company or has done any of these in the previous five financial years (Section 90(2)). A third aspect is that audit committees have the duty to nominate a registered auditor for appointment who in their opinion is independent of the company (Section 94(7)).

How does it fit globally?

The UK regulator, Financial Reporting Council, requires the disclosure of audit firm tenure in the audit committee report. The US regulator, Public Company Accounting Oversight Board, also proposed disclosure of audit tenure in the Auditor's Reporting Model Proposal where long form audit report requirements are suggested.

Taking on new form

The number of years would also include the former years of audit when a firm existed in another form, other than its current, where a merger or de-merger has taken place.

Tying the laces

Audit tenure is one of the many ways in which transparency is enhanced. It cannot be considered in isolation, but is merely one of the many factors that stakeholders should consider when evaluating entity-auditor relationships.

In closing
Note from the Editor

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Dear colleagues

I hope you have enjoyed reading this 21st issue of Technically Speaking.
I hope that this issue has given you some insights into the accounting and regulatory world.

Please continue to send your comments and suggestions that you may have to improve our future issues to: technicallyspeaking@deloitte.co.za.

Kind Regards
Nyamu Makhuvha

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