16th Edition – January 2014

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Technically Speaking
A balanced outlook

Accounting & Auditing – External

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Welcome

Dear colleagues

Welcome to our sixteenth edition of Technically Speaking!

This edition includes articles on the following topics:

The Automotive Production and Development Programme (APDP)
The APDP programme has been introduced to provide incentives to motor manufacturers. This article provides guidance on the programme as well as on the types of assurance reports which can be issued in terms of the programme.

Companies Act: Financial Distress
The Companies Act, 2008 introduced a definition of financial distress. This article provides a close examination of when a company is considered to be in financial distress.

Leases Exposure Draft
The International Accounting Standards Board (IASB) finally issued the long awaited leases exposure draft. This article explores what impact the proposals could have on your business.

Impairment Exposure Draft
As part of its financial instruments project, the IASB issued the latest exposure draft on the proposed treatment of impairment of financial assets. This article highlights the differences between the current requirements and the new proposals.

We look forward to your comments on this publication. Please feel free to contact our editor Naomi Murigi if you have any questions or suggestions for future issues.

Kind regards

Nita Ranchod
Business Unit Leader
Accounting & Auditing

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Automotive Production and Development Programme (APDP)

Article by:

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Overview of the Programme

South Africa's automotive industry is the country's largest manufacturing sector, contributing an estimated 6.8% of the country's gross domestic product in 2011. Included in this contribution is the manufacturing of motor vehicles and automotive components, as well as the related retail, distribution and servicing activities. The automotive industry also has a significant multiplier effect on the metals (steel, aluminium and platinum), plastics, leather and textile industries.

The local production of passenger motor cars is undertaken by the subsidiaries of seven global automotive companies i.e. BMW, Ford, General Motors, Mercedes-Benz (Daimler AG), Nissan, Toyota and Volkswagen (VWSA). These companies all manufacture motor vehicles for the local and export markets. Supporting the production of light motor vehicles are a significant number of component manufacturing companies based in South Africa.

In the National Association of Automotive Manufacturers of South Africa (NAAMSA) review of business conditions for the new vehicle manufacturing industry / automotive sector for 2013, it is projected that capital expenditure will amount to some R5.0bn for 2013 by the seven major vehicle manufacturers and two major truck producers. NAAMSA also anticipates that the production of passenger vehicles will rise from 274 873 in 2012 to 320 000 vehicles in 2013 and the production of light commercial vehicles from 235 741 to 300 000 vehicles during the same period. The introduction of the APDP is intended to increase the production of passenger cars and light commercial vehicles to some 1 200 000 vehicles by 2020.

Due to the undoubted importance of the automotive industry to the economy, any incentives designed to stimulate investment to the extent indicated above should be welcomed, including the recently introduced APDP.

In July 2012, the draft legislation dealing with the APDP was revealed to the public. The APDP replaced the Motor Industry Development Programme (MIDP) with effect from 1 January 2013.

The Regulations for the Administration of the APDP:

Applicants for registration are required to comply with the Regulations and Guidelines prepared by ITAC relating to the administration of the APDP. The Regulations are dealt with in six parts, as follows

- PART A – Definitions
- PART B – General Provisions
- PART C – Production Rebate Credit Certificate
- PART D – Calculation of the CSP for VAA purposes
- PART E – Imported Component Values
- PART F – Transitional Notes

The APDP Guidelines prepared by ITAC are known as 'Info Docs'. There are three Info Docs at present, as follows -

- Info Doc A/2013: Detailed Information on Production Rebate Credit Certificates (PRCCs)
- Info Doc B/2013: Company Specific Percentages used in the calculation of the Volume Assembly Allowance
- Info Doc C/2013: Declaration of Imported Component Values (Form C1)

Key differences between the incentives under the APDP and the MIDP:

There are four incentives under the APDP and, similarly, there were four incentives under the MIDP. These are as follows:

Focus:

- The MIDP was an export-based incentive programme whereas the APDP is local production focused.

Import Duty:

- Under both the MIDP and APDP, the vehicle manufacturer (OEM) has a duty liability on the imported components and on the import content of locally sourced components used in the local manufacturing of light motor vehicles.
- This duty liability is currently equal to 20% of the customs value of imported original equipment components (OECs).
- There is also a duty liability equal to 25% of the customs value of fully imported vehicles, otherwise known as completely built-up units (CBUs).

Volume Assembly Allowance (VAA):
- The DFA will be replaced by the VAA at an initial rate of 20% and will be gradually reduced by 1% annually to 18% by 2015, remaining fixed until 2020.
- The VAA is only available to OEMs and is aimed at enabling OEMs who produce 50 000 or more vehicles annually (in total and not by individual model) to receive an additional allowance irrespective of their market focus i.e. local or foreign.

The Production Incentive (PI):
- The PI or Production Rebate Credit Certificate (PRCC) effectively replaces the IRCC incentive system by changing the calculation to be based on production output as opposed to export values.
- The incentive still remains a local value-added incentive in that the foreign currency usage costs incurred would still be deducted from the local or free-on-board export sales invoice prices.
- Also to be deducted from the invoice price are 75% of any ‘standard materials’ plus 100% of any other non-standard materials.
- For ‘vulnerable industries’ only 60% of any ‘standard materials’ plus any other non-standard materials need to be deducted. This percentage increases by 5% per annum from 1 January 2015 to 75% from 1 January 2017.
- The PI is in the form of a tradable duty credit of 55% of the value-added element of manufactured vehicles.
- This incentive percentage will reduce by 1% per annum to 50% over five years.
- An additional PI of 25% is available for the vulnerable sub-sectors and will reduce by 5% per annum from 1 January 2015 to 50% from 1 January 2020.
- The calculated PI is an import duty credit to be applied as a rebate against future automotive imports or to be used as a refund on past component or motor vehicle imports.

The Automotive Investment Scheme (AIS):
- The AIS makes targeted cash grants to support the growth and development of the automotive sector. It rewards investment in new and/or replacement models and components that will increase plant production volumes, sustain employment and/or strengthen the automotive value chain.
- Applications can be made by light motor vehicle or component manufacturers that are investing in their productive capacity. Any contributions to the tooling industry and to the OEM’s own R&D activity will enhance the benefit.
- The AIS provides for a base cash grant of 20% of the value of qualifying investment in productive assets, as approved by the Dti.
- An additional cash grant of 5% or 10% may be available for ‘strategic projects’ that achieve additional production volumes, demonstrate defined increase in turnover, demonstrate support for the development of the local tooling industry or expend defined contributions to research and development in South Africa.
- Projects by component manufacturers below R1 million and by light motor vehicle manufacturers below R30 million will not qualify for AIS benefits.
- Projects already qualifying from other capital incentives offered by the Dti will not also qualify for AIS benefits.
- Applications are to be submitted to the Dti.
- The Dti’s Programme Guidelines (refer to paragraph 3.2 of the Guidelines) on the AIS indicate that the benefits are subject to income tax. However, in the Taxation Laws Amendment Act 2012, a new section 12P (Exemption of amounts received or accrued in respect of government grants) and Eleventh Schedule (Government Grants Exempt From Normal Tax) were added into the Income Tax Act, 1964. Benefits under the AIS are now received tax free and corresponding adjustments are required to be made to the underlying base costs of any productive (allowance) assets affected by the AIS thereby reducing the amount qualifying for a tax deduction.
- The Dti has also introduced a People Carrier Automotive Investment Scheme (P-AIS). This is a sub-component of the AIS and is designed to stimulate a growth path for the people-carrier vehicle industry. The commencement date is 1 November 2012. For SKD investments and component manufacturers, the cash grant benefit is 20% of qualifying investments in productive assets and for CKD investments the incentive is 25% or 20%. If certain economic benefit criteria are met, SKD and CKD investments projects can qualify for an additional incentive of 5% and component manufacturers can qualify for an additional 10%. The cash grant is payable over 3 years and will also be exempt from income tax. There is an additional benefit available for qualifying component manufacturers in the form of a competitiveness improvement grant.

Assurance requirements:

On 26 June 2013, the Independent Regulatory Board for Auditors (IRBA) approved four audit reports in connection with the APDP. These are as follows:
- The Production Rebate Credit Certificate (PRCC) Report: Relating to the calculation of the PI and application for IRCCs.
- The Imported Component Values (Form C1) Report: Relating to the declaration of imported component values used in the calculation of a light motor vehicle manufacturer’s liability for customs duties on imported components used in the production of light motor vehicles for local sale.
- The Standard Materials Declaration (SMD) Report: Relating to the declaration of standard materials used in the calculation of the PI.
- The Company Specific Percentage (CSP) Report: Relating to the

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Automotive Production and Development Programme (APDP)

application for company specific percentages used in the calculation of the volume assembly allowance by light motor vehicle manufacturers producing at least 50 000 units per annum.

It is the responsibility of the reporting auditors to express an opinion on the Application or Declaration based on the evidence they have obtained. The auditors are required to conduct their reasonable assurance engagements in accordance with the International Standard on Assurance Engagements 3000, Assurance Engagements other than Audits or Reviews of Historical Financial Information (ISAE 3000), issued by the International Auditing and Assurance Standards Board. That standard requires that the auditors plan and perform the engagements to obtain reasonable assurance about whether the Application or Declaration is free from material misstatement.

A reasonable assurance engagement in accordance with ISAE 3000 involves performing procedures to obtain evidence about the amounts and disclosures in the Application or Declaration. The nature, timing and extent of procedures selected depend on the assurance provider's judgment, including the assessment of the risks of material misstatement, whether due to fraud or error, in the Application or Declaration. In making those risk assessments, the auditors should consider internal controls relevant to the Company's/Close Corporation's preparation of the Application or Declaration.

As there are no prescribed audit procedures to be undertaken when auditing Applications and Declarations, each auditor will be required to design his own procedures.

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The Companies Act

When is a company financially distressed, and what does it mean?

Article by:

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Chapter 6 of the Companies Act, 2008 (the Act) deals with business rescue. Business rescue is largely self-administered by the company, under independent supervision within constraints set out by the Act, and subject to court intervention, at any time, on application by any of the stakeholders.

For purposes of business rescue, it is important to understand the meaning of "financial distress", as the requirements of Chapter 6 of the Act are triggered as soon as a company is in financial distress. Where a company is in financial distress, and the company failed to either adopt a resolution to go into business rescue, or provide written notice to shareholders, employees and creditors that it decided not to adopt business rescue, a reportable irregularity exists.

Financial distress

The Companies Act defines "financially distressed", to mean that it appears to be:

i. reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months, or
ii. reasonably likely that the company will become insolvent within the immediately ensuing six months.

The first part of the test seems clear. A company will be in distress if there is a reasonable likelihood that the company may reach a position within the next six months where it will no longer be able to pay its debt as it becomes due and payable. "Reasonable likelihood" implies that there must be a rational basis for the conclusion that the company may not be able to pay its debt within the next six months. This conclusion amounts to an educated prediction, based on the current financial position of the company, and considering the all relevant factors that may impact the company's liquidity in the foreseeable future.

The second part of the financial distress query deals with insolvency, and here the question often arises as to whether this refers to factual (technical) insolvency or commercial insolvency. There are conflicting views. Some say that because part (i) clearly deals with commercial insolvency, part (ii) must deal with factual insolvency (i.e. a balance sheet test). In terms of this approach, a company is regarded as technically insolvent (and thus financially distressed) if the liabilities of the company exceed the assets. This approach does not take into account subordination agreements, or any other management action. Others say that one must consider the definition in conjunction with the definition of business rescue and the objectives of the Act pertaining to business rescue.

When interpreting these particular provisions one needs to consider the purpose of the Act in this regard i.e. to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders. In turn, "rescuing the company" means achieving the goals set out in the definition of "business rescue". Business rescue means proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for:

- The temporary supervision of the company, and of the management of its affairs, business and property;
- A temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and
- The development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximizes the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company.

It should be clear from the above that business rescue is meant to be employed only where a company needs 'rehabilitation', and where there is a need to 'rescue' the company. If the purpose of the Act and the purpose of business rescue are considered, it seems unlikely that a company that is factually insolvent, but still able to service its debt, can be regarded as financially distressed.

It is our view that for purposes of part (ii) of the financial distress test one should consider the complete financial position of the company rather than merely technical insolvency. We belief that, in order to adhere to the purpose of the Act, and in light of the definition of business rescue, one must consider the complete financial position of the company when determining whether there is a "reasonable" likelihood that the company will be insolvent within six months. In terms of this approach a company will only be regarded as in "financial distress" where it is insolvent even after all other circumstances were considered, including any other valuations of the assets and liabilities, reasonably foreseeable assets and liabilities per the solvency and liquidity test in section 4 as well as any other proposed measures taken by management such as subordination agreements, recapitalisation, or letters of support, etc. This approach was confirmed in a recent Supreme Court decision in the United Kingdom where the court found that the "balance sheet" test for insolvency must take account of wider the commercial context, and that courts must look beyond the assets and liabilities used to prepare a company's statutory accounts when deciding whether or not a company is balance sheet insolvent.

By employing the narrower definition of "financial distress" (i.e. a balance sheet tests for solvency which excludes subordination agreements and other management action) one arrives at an answer that may not serve the best interests of affected parties (shareholders, creditors and employees). There is very little point in writing to affected parties, informing them that the company is financially distressed when it is in fact perfectly able to continue to do business. This approach does not support the purpose of the Act, and may have a detrimental effect on both the company and its stakeholders.

Financial distress requires action

Where a company is in financial distress, the Act determines as follows:

129. Company resolution to begin business rescue proceedings.—(1) … the board of a company may resolve that the company voluntarily begin business rescue proceedings and place the company under supervision, if the board has reasonable grounds to believe that—
(a) The company is financially distressed; and
(b) there appears to be a reasonable prospect of rescuing the company.

(7) If the board of a company has reasonable grounds to believe that the company is financially distressed, but the board has not adopted a resolution contemplated in this section, the board must deliver a written notice to each affected person …. and its reasons for not adopting a resolution contemplated in this section.

Reportable irregularity

If a company is financially distressed, but the directors have taken no further action as required in section 129 of the Act, then a reportable irregularity exists. Non-compliance with this requirement may cause financial loss to many parties, including shareholders, employees and creditors. Furthermore, it may point to a material breach of fiduciary duty, since the directors have a responsibility to deal with the company openly and in good faith.

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Leases exposure draft (ED 2013/6)
The overhaul to lease accounting

Article by:

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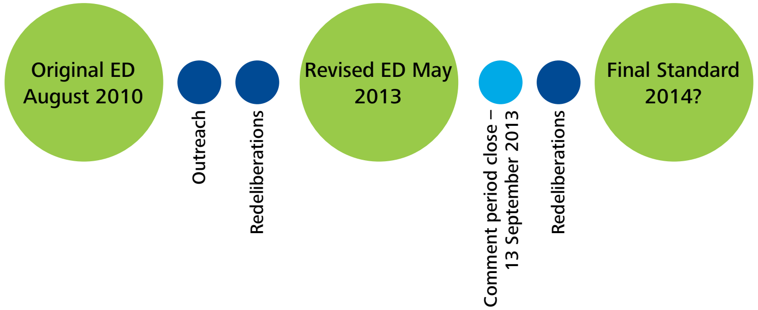
Background

The International Accounting Standards Board (IASB) has re-exposed its proposed approach for the recognition and measurement of leases. The 2013 exposure draft (ED) is the latest step in a long-running project to improve financial reporting of lease contracts and address criticisms that the existing model fails to satisfy the needs of users of the financial statements.



Although the IASB board members who embarked on this project have since retired from the IASB, the current chairman of the IASB appears equally forthright in his intentions to develop a standard that will reflect lease commitments in the statement of financial position. In a speech at the London School of Economics in November 2012, IASB Chairman Hans Hoogervorst stated "call it a lease and miraculously it does not show up in your books. In my book, if it looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck. So is the case with debt – leasing or otherwise."

What is a lease?

A contract contains a lease if fulfilment of the contract depends on the use of an identified asset and the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

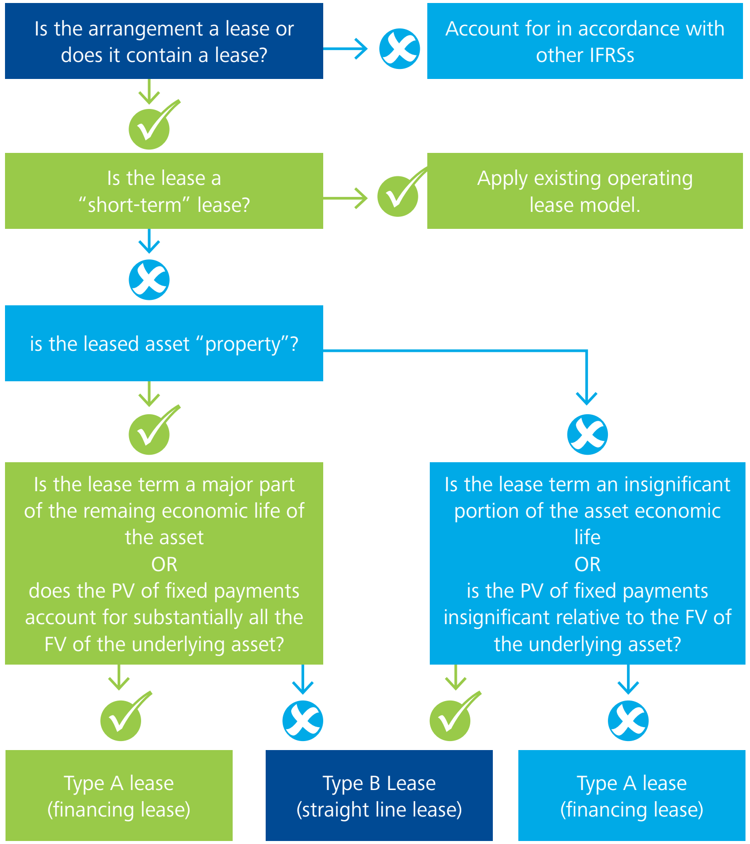
The proposal includes additional guidance on the assessment of contracts that may contain a lease. For example, contracts for bandwidth of a fibre-optic cable that is less than substantially all of the capacity of the cable is not a lease.

Short-term leases

The proposals do not apply to a lease that, at commencement date, has a maximum term, including extension options, of 12 months or less.

Classification of a lease

The classification of a lease impacts the accounting treatment for both lessees and lessors.



Lessor accounting

Type A leases, the lessor will:

- derecognise the underlying leased asset
- recognise a lease receivable equal to the present value of minimum lease payments
- recognise a residual asset being the sum of the present value of any unguaranteed residual, variable lease payments not included in the lease receivable and an allocation of profit relating to the residual asset
- recognise profit on the portion of the asset leased immediately in profit or loss and
- recognise the unwinding of interest on the lease receivable and residual asset in profit or loss over the lease term.

Type B leases, the lessor will:

- typically have no accounting implications on profit or loss of the statement of financial position at commencement of the lease
- account for the leased asset as investment property or depreciate using the principles for owned assets and
- recognise income in profit or loss on a straight line or other systematic basis over the lease term, similar to current operating lease accounting for lessors.

Lessee accounting

Initial measurement:

Regardless of the classification as a Type A or B lease, for all leases greater than 12 months, the lessee recognises:

- the present value of lease payments as a liability and
- a corresponding right-of-use asset.

Subsequent measurement:

Type A leases:

- recognise interest on the liability and amortisation of the right-of-use asset
- calculate amortisation based on the consumption of the asset's economic benefits.

This would generally result in a straight line amortisation expense.

Type B leases:

- recognise interest on the liability and
- amortisation of the right-of-use asset.

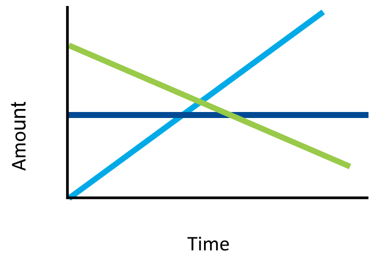
Amortisation is calculated as the difference between a straight line lease expense and interest on the lease liability. The interest and amortisation on a type B lease will be reflected as a single operating expense in profit or loss (i.e. will not be presented as interest and amortisation for profit or loss purposes).

The example below indicates the implications for Type A and B leases for lessees:

Type A	0	1	2	3	4	5
Cash payments		1 000	1 100	1 200	1 300	1 400
Discount rate	12%					
Present value	4 244					
Straight line	1 200					
Liability	4 244	3 754	3 104	2 277	1 250	-
Asset	4 244	3 395	2 546	1 698	849	-
Interest expense		509	450	373	273	150
Amortisation		849	849	849	849	849
Total expense in P&L		**1 358**	**1 299**	**1 221**	**1 122**	**999**

Type B	0	1	2	3	4	5
Cash payments		1 000	1 100	1 200	1 300	1 400
Discount rate	12%					
Present value	4 244					
Straight line	1 200					
Liability	4 244	3 754	3 104	2 277	1 250	–
Asset	4 244	3 554	2 804	1 977	1 050	-
Interest expense		509	450	373	273	150
Amortisation		691	750	827	927	1 050
Single lease expense in P&L		**1 200**	**1 200**	**1 200**	**1 200**	**1 200**

The graph below reflects the profiles of leases reflecting the typical payment profile and profit or loss impact for Type A and Type B leases.



How will the proposals impact your business?

The proposals will significantly impact the way the entity's financial performance and position is presented.

- Increased judgement will be required to assess multiple-element arrangements and cash flows under lease contracts.
- Financial statement metrics and ratios will change dramatically, particularly for lessees where the statement of financial position will reflect increased investment in resources and debt financing.
- Operational complexity and data collection will increase the financial reporting burden for preparers.
- Systems may need to be amended or implemented to cater for the financial statement implications of the proposals.
- Performance targets and contractual arrangements linked to traditional financial statement metrics will need to be revised.
- Internal resources will be required to implement the proposals and monitor on-going lease activities.
- Buy versus lease decisions may be impacted by the proposals as lease liabilities are incorporated into the lessee's statement of financial position.
- Tax implications of leases may not follow the proposal in the ED.

Our observations

- The Board has decided to define the border between Type A and Type B leases based on whether the lessee consumes more than an insignificant part of the underlying asset. This will result in most leases, with the exception of property leases, being classified as Type A leases.
- The lessee model does not mirror the lessor model. The underlying leased asset in a Type B lease is reflected on the lessee and lessor financial statements.
- The distinction between lease and service contracts becomes imperative as lessees will capitalise all lease contracts.
- The determination of the lease term may require extensive judgement especially where the lease is for a strategic asset or is in a strategic location.
- Diversity and structuring opportunities may arise in the assessment of whether variable payments are "in-substance" fixed payments.
- Retrospective application will require extensive implementation efforts.

Forward looking view for calculating credit impairments

Article by:

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The Exposure Draft ED/2013/3 Financial Instruments: Expected Credit Losses (the ED) was published by the International Accounting Standards Board (IASB) on 7th March 2013. Under this ED, fundamental changes have been made to the philosophy of the credit impairment calculation. The proposed standard aims to create an impairment methodology that is forward looking in order to achieve earlier recognition of credit impairments. This revised methodology is referred to as an expected loss approach whereas historically an incurred loss approach was prescribed under IAS 39 Financial Instruments: Recognition and Measurement (IAS 39). These changes will not only impact traditional lenders, but may also have far-reaching ramifications on corporate entities, such as those in the telecommunication sector. These entities may be required to record receivables upfront for certain transactions per the proposed revenue standard whilst accounting for any resulting impairment according to the principles of this ED.

Overview of main changes:

To highlight the primary difference between the expected and incurred loss approaches, consider the following example:

A bank has a customer with an overdraft facility. At the start of the financial year, this customer has a facility of R100, 000 of which R50, 000 has been drawn. This customer loses a major order which results in financial difficulty. Two months after the loss of the order, the entity ceases to pay the instalments owing to the bank. According to the bank's default definition, the customer is defined as being specifically impaired after three missed payments, at which point the customer has drawn R75,000 of their overdraft facility.

Under IAS 39, the bank is only required to raise a provision when the loss event (i.e. the loss of the order) has occurred. This is referred to as the incurred loss approach. At the start of the year, no impairment will be held relating to this specific customer as a loss event has not yet occurred. However, lenders generally account for impairments on a portfolio basis as a portion of customers in the portfolio will have experienced a loss event even though this has not been evidenced to the bank. The loss event will be evidenced to the bank through an instalment being missed. The period between a loss event occurring and it being evidenced is generally referred to as an emergence period.

Under IAS 39, the bank may calculate the impairment relating to this account at the start of the year (i.e. prior to the client having evidenced a loss) as follows:

IAS 39 illustrative calculation:

Impairment = Roll rate (1) * Probability of default(1) * Loss % * Balance[1]	
Where:	
Roll rate (1):	The probability of an account moving to 1 instalment in arrears over the emergence period (e.g. 1.5%)[2]
Probability of default (1):	The probability of an account being specifically impaired once 1 instalment has been missed (e.g. 50%)[3]
Loss %:	The percentage of the balance that will not be recovered at the point of default (e.g. 60%)
Balance:	The outstanding balance at the point of calculation (R50,000)
Impairment (performing):	1.5% * 50% * 60% * R50,000 = R225

Under the new ED, several fundamental changes will be made to the above approach. Firstly, rather than having to raise impairments as soon as a loss event occurs, lenders will now have to hold impairments equal to expected losses for a 12 month time horizon for all performing loans. For most loans, this will change to a lifetime expected loss basis upon a significant deterioration in the credit risk of a loan since inception[4]. Another change relates to the estimation of future drawdowns for loan commitments and financial guarantees that are not held at fair value through profit and loss (FVTPL). The bank will have to estimate the future drawdowns that will occur between calculation date and the date that the client will be specifically impaired and include this estimation in the impairment calculation.

1 It should be noted that this calculation is generally performed on a portfolio basis for retail and middle-market portfolios.
2 The missing of an instalment is generally regarded as when the loss event is evidenced to the lender.
3 In our example, this is the probability of an account that has missed 1 instalment eventually missing 3 instalments.
4 Note that lifetime expected losses will need to be held from inception for purchased or originated credit-impaired financial assets.

Under the new ED, the bank may calculate the impairment relating to this account at the start of the year (i.e. prior to the client having evidenced a loss) as follows:

New ED illustrative calculation:

Impairment = Probability of default * Loss % * Exposure at default	
Where:	
Probability of Default:	The probability of a performing account being specifically impaired over a 12 month time horizon (e.g. 5%)
Loss %:	The percentage of the exposure at default that will not be recovered at the point of default (e.g. 60%)
Exposure at default:	The predicted drawn balance at the point of the account being specifically impaired (e.g. R75,000)
Impairment (performing):	5% * 60% * R75,000 = R2,250

From the example above, it is clear that lenders will need to hold increased impairments on their performing customers when compared to the current treatment under IAS 39.

The ED proposes a new set of rules relating to the use of forecasts, discount rate and the interest recognition for impaired accounts.

- The ED specifies that reasonable and supportable forward looking information can be incorporated into the impairment calculation. This is a clear change from the current approach where lenders are specifically prohibited from using information relating to uncertain future events.
- Lenders are provided with discretion relating to the discount rate for performing loans under the new ED, and this may range from a risk-free rate to the loan's effective interest rate.
- Interest revenue for specifically impaired loans is calculated by applying the effective interest rate to the amortised cost balance, which comprises the gross carrying amount adjusted for any impairment.

Practical considerations:

The change in the impairment philosophy will have strategic and operational ramifications for lenders in addition to the modelling implications.

- Accounting policies will need to be instituted surrounding discretionary aspects such as discount rates and the definition of credit deterioration;
- Governance frameworks will need to be revised to ensure accountability of inputs as protocol relating to the use of forecasts;
- The role and skills of the internal audit function will have to be revised in light of the new requirements; and
- As the proposed methodology is more closely aligned to Basel, corresponding skills, systems and methodologies will need to be leveraged where possible.

Making the journey worthwhile:

There are numerous benefits that may arise as a result of implementation including but not limited to:

- Possible reduction of volatility in impairments as well as interest income recognised on defaulted accounts;
- Increased data integrity and systems capability; and
- Increase in the variety of information that will be available to management to facilitate business decisions

So what now?

Although the ED had specified an implementation date for financial periods beginning on or after 1 January 2015, the IASB has removed this mandatory effective date temporarily and will determine a new mandatory effective date. In spite of the expected delay in the implementation date, there are certain considerations that entities should be thinking about at present. These include performing readiness assessments as well as focussing on strategic, governance, data, and process ramifications of the new ED. Following on from this exercise, roadmaps and project plans can be developed.

The implementation of the proposed standard will possibly be the biggest change in lenders' financial reporting frameworks since the introduction of IFRS. The complexity of the new impairment approach requires organisations to not only understand the challenges, but also to implement practical initiatives to handle those challenges and to extract business benefits as part of the journey.

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In closing
Note from the Editor

Dear colleagues

I hope you've enjoyed reading this issue of Technically Speaking and that it has provided you with a valuable update on the latest developments in the accounting and regulatory world.

Please continue to send your comments and suggestions to improve our future issues to technicallyspeaking@deloitte.co.za.

Kind regards

Naomi Murigi

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