ISSUED AUGUST 2019

FEEDBACK STATEMENT – ED 167 *PROPOSED REVISION OF GRAP 104 ON FINANCIAL INSTRUMENTS*

This feedback statement outlines the comments received on ED 167 as well as a summary of the key revisions to GRAP 104 (2019)	**Overview**	The Board proposed amendments to GRAP 104 to align it to the international standards on which it is based, i.e. IFRS 9 on *Financial Instruments* and IFRS 7 on *Financial Instruments: Disclosures.*
	Consultation process	The Board approved ED 167 for issue in May 2019 with a comment deadline of 7 December 2018. The final amendments to GRAP 104 on *Financial Instruments* were approved by the Board in March 2019.
	Supporting material	Analysis of written and verbal comments received on ED 167. Final amendments to GRAP 104 on *Financial Instruments (2019).* Fact Sheets on specific transactions.
	Next steps	The Board issued ED 177 outlining proposed transitional provisions and an effective date for the revisions to GRAP 104. The comment deadline is 29 November 2019.

ACCOUNTING STANDARDS BOARD

FEEDBACK STATEMENT

ED 167 – PROPOSED REVISION OF THE STANDARD OF GRAP ON FINANCIAL INSTRUMENTS

What did we hear?	
General support for changes	Respondents generally expressed support for the changes. Much of the feedback received during the consultation process will help in developing FAQs, the transitional provisions, or assist the National Treasury with the development of implementation guidance. A description of the key issues raised by respondents and the Board or Secretariat's responses are is outlined below.
Scope of GRAP 104	
Are letters of support financial guarantee contracts?	Respondents supported the inclusion of financial guarantee contracts and loan commitments in GRAP 104. Respondents questioned whether letters of support are financial guarantee contracts, as well as whether the subordination of loans is a form of financial guarantee. Most of the arrangements mentioned by respondents related to group entities where the parent makes specific promises to the subsidiary regarding its financial position. The definition of a financial guarantee requires that the guarantor must guarantee a specific debt instrument between a borrower and a lender. General promises to pay for financial shortfalls, certain operational expenditure, or generally ensure the financial viability of an entity, are not financial guarantee contracts. Guidance was added to the Application Guidance to explain the key components of a financial guarantee contract as well as provide explanatory commentary on letters of support. The basis for conclusions was also updated. Subordinated loans are not financial guarantee contracts as they do not meet the definition. Entities that subordinate loans would need to assess whether they are in fact still loans (rather than a residual interest), and if yes, consider whether they should be measured at fair value or amortised cost. Subordination agreements also affect the calculation of expected credit losses. These issues were already dealt with in the application guidance.

FEEDBACK STATEMENT

ED 167 – PROPOSED REVISION OF THE STANDARD OF GRAP ON FINANCIAL INSTRUMENTS

Scope of GRAP 104	
Can an entity apply economic hedging even though there are no requirements for hedge accounting?	Respondents supported the position reached by the Board that there is no need for hedge accounting requirements in GRAP 104. If entities wish to apply hedge accounting, they apply the requirements outlined in IFRS 9. Questions were raised about whether economic hedging can continue in the absence of requirements for hedge accounting. Subject to the legal limits within which entities operate, economic hedging may continue as this is an operational decision that is separate from accounting. A discussion has been added to the basis for conclusions explaining this position.
What are common areas where the definition of a financial instrument is misapplied?	In consulting on the proposed amendments to GRAP 104, there were a number of areas where stakeholders incorrectly believed that a specific transaction was a financial instrument. For a transaction to be a financial instrument, it must arise from a contract, and be settled in cash or another financial asset. Some common areas of misapplication include: receivables and payables that arise from legislative (statutory) requirements – taxes, fines and levies; and prepayments or advance receipts – which are typically settled by receiving or providing goods or services and not cash. There are transactions where the treatment may require the application of judgement to assess whether the definition of a financial instrument is met, and will often depend on how an entity intends to settle a transaction. These transactions include (but not limited to) consumer deposits and bursaries where repayment is required if the employee is unsuccessful in his/her studies.
Initial measurement of financial instruments	
How should day 1 discounting be done?	It was observed that entities incorrectly apply day 1 discounting (i.e. to assess whether the initial recognition of a revenue or expense transaction should be separated between revenue/expense and interest). Entities often take the year-end balance of receivables and payables and calculate interest based on that balance and deem this to be 'day 1 discounting'. Day 1 discounting is done at initial recognition for the initial interest free credit period granted (if any). Any subsequent delays in payment affect the calculation of impairment losses. An FAQ will be developed by the Secretariat explaining the correct application.

Initial measurement of financial instruments	
Is day 1 discounting and separating transactions between sales and interest revenue consistent with IGRAP 1?	Questions were raised about whether the guidance on day 1 discounting and the separation between revenue from the sale or provision of good or services and interest revenue is consistent with IGRAP 1 on *Applying the Probability Test on Initial Recognition.* The guidance on day 1 discounting indicates that all revenue should be recognised, but that the full transaction amount should be separated between revenue and interest. As a result, there is no conflict. A FAQ will be issued to explain this to stakeholders.
How should the non-exchange component of a concessionary investment be determined?	A concessionary investment is an arrangement that includes both an investment and a non-exchange component. This type of investment could include investments in residual interests of other entities – particularly where the investment is made for specific social or other policy objectives. ED 167 focused on whether the terms and conditions of the arrangement separately identified a non-exchange component. Respondents indicated that, while the arrangement should be considered, substance over form should be applied. The application guidance and basis for conclusions were amended accordingly.

Classification of financial instruments for purposes of subsequent measurement	
General support for change in classification of financial instruments	Entities need to decide whether to measure financial instruments subsequently at amortised cost or fair value. ED 167 outlined specific criteria to be used when making this assessment. Respondents generally supported the change in classification of financial assets. The most significant changes relate to the classification of financial assets, which is now principles-based. In classifying a financial asset, an entity analyses the: • nature of the cash flows - whether the cash flows are solely payments of principal and interest (SPPI), i.e. consistent with a basic lending arrangement; and • reasons why an entity holds and instrument - to hold to collect contractual cash flows or not, i.e. the management model applied. Instruments held to collect the contractual cash flows can be measured at amortised cost if they also meet the SPPI test. Fair value is used in all other instances.

Classification of financial instruments for purposes of subsequent measurement	
General support for change in classification of financial instruments (contd.)	Based on these criteria, investments in residual interests (equity instruments) would need be measured at fair value. The Board agreed to continue to permit the use of cost where a reliable measure of fair value is not available. Respondents requested that implementation guidance be provided on the types of features that would fail the SPPI test, and at what level the management model should be applied. Guidance was also requested on how to deal with reclassifications of financial instruments, both on initial adoption and once the revisions to the Standard have been adopted. Guidance on reclassifications of instruments on initial adoption has been considered in developing the transitional provisions. Guidance is already included on the reclassification of financial assets in the revisions to GRAP 104.
How should bank accounts be classified?	Questions were asked about the classification of bank accounts. Bank accounts such as transactional bank accounts, short term deposits, call accounts etc. generally meet the SPPI test because their terms are consistent with a basic lending arrangement. Bank accounts are usually repayable on demand and therefore meet the management model to collect contractual cash flows The Secretariat will develop a separate Fact Sheet for bank accounts as this seems to be an area of potential divergence in practice.
Should all concessionary loans be measured at amortised cost?	Some concessionary loans may fail the SPPI test, particularly if they have contingent repayment features. This means that they will need to be measured at fair value rather than at amortised cost (which was the most likely classification under the previous requirements in GRAP 104). Some respondents did not believe that measuring any concessionary loans at fair value is appropriate as the entities that provide these loans (and the users of their financial statements), do not manage the market risk on these loans. They are usually only interested in the amount lent and repayments. They did not believe that including the exposure to market risk in the valuation of the loan on an ongoing basis was appropriate. Other respondents were of the view that measurement at fair value faithfully represents the economic substance of the loan. They also noted that applying the expected credit loss model to concessionary loans, particularly those with contingent repayment features, may be onerous. Concerns were also expressed about making rules for specific transactions, and the ability of the Board to adequately define concessionary loans such that there is no accounting arbitrage.

Classification of financial instruments for purposes of subsequent measurement	
Should all concessionary loans be measured at amortised cost (contd.)?	The Board agreed that the revised classification principles should be applied to all instruments so that rules are not made for specific transactions. The Board also believed that the measurement of certain concessionary loans at fair value provided the most relevant information to users as it reflected the underlying characteristics of the loans.
When should investments in residual interests be measured at cost?	Most respondents supported the retention of the requirements in GRAP 104 regarding the measurement of investments in residual interests where fair value cannot be reliably measured. They noted that, because the investments are most often unquoted and there is limited information about cash flows, it is difficult to determine fair value. Some respondents were concerned that the practical expedient may be abused by entities, and that entities may not try to determine fair value and automatically revert to cost. They suggested that cost should only be permitted when the investment was made to generate "service potential", and that there should be disclosure in the notes to the financial statements explaining why fair value could not be determined reliably. Limiting the use of cost to investments that generate service potential may be inappropriate, particularly because it may be difficult to decide if an investment is made solely for service potential as this may change over time. It may also be difficult to determine the fair value for investments that generate cash flows, particularly if the range within which inputs to a valuation technique may lie is wide. The Board retained the requirements in ED 167, but included a disclosure requirement indicating why fair value could not be determined and explaining the consideration of the issue in the basis for conclusions.
How should fair value be determined for unquoted investments in residual interests (equity instruments)?	Respondents noted that they often use external valuers to value unquoted equity instruments and that these valuers use a range of techniques. The acceptability of these techniques was questioned. The Board added Example 26 to 29 in Appendix C illustrating the most common techniques used to value unquoted equity instruments. This guidance is drawn from IPSAS 41 on *Financial Instruments* (which was drawn from educational material published by the IASB on IFRS 13 *Fair Value Measurement).*

Subsequent measurement of financial instruments

Was there support for the revised impairment model?	The impairment model proposed in ED 167 is different to the existing model in GRAP 104. ED 167 proposed using an 'expected' credit loss impairment model, while GRAP 104 currently uses an 'incurred' credit loss model. The new model requires an entity to consider expected credit losses using information on credit risk that assesses both historical, present and forward-looking data (that is available without undue cost or effort). Changes were also proposed on how interest revenue should be calculated, depending on whether the financial asset is impaired. Respondents generally supported the proposed impairment model. Issues were however raised about the following: • All municipalities have large debtors' book but have relatively simple credit management practices and supporting systems. Respondents indicated that there should be sufficient relief provided to simplify the impairment model for receivables. The Board agreed to three areas of relief: An entity only needs to assess credit losses over the lifetime of the instrument (for other assets - an entity needs to assess whether it should use lifetime or 12 month credit losses), a credit matrix can be used to calculate impairment losses, and interest revenue is always calculated using the gross carrying amount (for other assets - an entity uses a net basis to calculate interest). Respondents also requested that the National Treasury provide guidance on how to develop a credit matrix. This was shared with the National Treasury. • 'Write-offs' of debt in the public sector need to be done following specific legislative requirements. Guidance was included in the application guidance on this issue indicating that entities need to apply substance over form when preparing the financial statements. • Understanding the difference between 12-month and lifetime credit losses when calculating the loss allowance. While there is an explanation of this in the application guidance, the Secretariat will include an explanation in the Fact Sheets where impairment is discussed. • Information on changes in credit risk and expected credit losses available without undue cost or effort. Concerns were expressed about how 'undue cost or effort' will be interpreted by auditors. There is guidance in the application guidance, but this would require judgement to be applied by both the auditors and preparers.

Subsequent measurement of financial instruments	
Was there support for the revised impairment model?	• Changes would be required to existing systems and processes to implement changes to the calculation of interest revenue. Respondents noted that many of these calculations would need to be done outside the system, and that sufficient time should be allowed in the transitional provisions to ensure that these changes can be made. • The treatment of interest revenue on a financial asset that changes status, i.e. it is either no longer credit impaired, or the interest revenue is collected. A FAQ will be issued by the Secretariat to address this issue.
Disclosure of information on financial instruments	
Was there support for the new disclosures on concessionary loans?	ED 167 introduced new disclosures for concessionary loans granted by entities. One of the objectives of the disclosures is to illustrate the separation between the loan and non-exchange component on initial recognition. Depending on the subsequent measurement at amortised cost or fair value, other changes in the opening and closing balances of the loans are also presented. Respondents supported the presentation and disclosure requirements, except for the disclosure of the nominal values of the components of credit impaired concessionary loans. Respondents indicated that these disclosures are onerous, and that the availability of the information would depend on the valuation methodology applied. The Board agreed to delete this requirement.
Was there support for the other disclosures in ED 167?	Respondents generally supported the disclosures. Respondents were also asked to specifically comment on whether the disclosure requirement that the Board added in the initial development of GRAP 104 on the sufficiency of collateral held should be retained. Respondents expressed mixed views, but one respondent in particular questioned why this information would be needed as some loans have no collateral. The Board agreed that the holding of collateral is likely to be an operational decision that will affect the pricing and measurement of the instrument. The disclosure of the existence of the collateral is sufficient for users' needs. As a result, the Board deleted this requirement.

Executive summary of proposed amendments to GRAP 104	
Scope	The treatment of financial guarantee contracts and loan commitments has changed. Financial guarantee contracts issued by an entity and commitments made by an entity to provide loans on below market terms are financial instruments and are accounted for using GRAP 104. Previously these transactions were accounted for using GRAP 19 on *Provisions, Contingent Liabilities and Contingent Assets.* This meant either disclosing a contingent liability or recognising a provision, depending on whether the existence of an obligation was probable and could be measured reliably. GRAP 104 now requires an entity to measure these transactions at fair value, and if fair value cannot be determined reliably on initial recognition, by determining the loss allowance.
Classification of financial instruments	GRAP 104 (2009) classified financial instruments for purposes of subsequent measurement using specific rules outlined in the definitions. The default measurement for financial assets and financial liabilities was fair value. In the revised GRAP 104, financial assets are classified based on the following criteria: • nature of the cash flows, i.e. whether the cash flows are solely payments of principal and interest (SPPI) and its features are considered to be consistent with a ‘basic lending arrangement’; and • reasons why an entity holds and instrument, i.e. to hold to collect contractual cash flows or not. Instruments held to collect the contractual cash flows can be measured at amortised cost if they also meet the SPPI test. Fair value is used in all other instances. Where an entity cannot measure investments in residual interests at fair value, then as a practical expedient, cost can be used where a reliable measure of fair value is not available. For financial assets, the most significant change in classification will be to financial assets that had ‘fixed or determinable payments’. In GRAP 104 (2009) these would have automatically qualified to be measured at amortised cost. In GRAP 104 (2019), entities would need to assess the entity’s management model, and more importantly, whether the cash flows meet the SPPI test. Some instruments, particularly those where repayment is contingent on a specific activity, ratio, index, asset etc. are likely to fail the SPPI test and would need to be measured at fair value. Financial liabilities are measured at amortised cost, unless they meet specific circumstances or are specific types of transactions, e.g. liabilities held for trading, derivatives, financial guarantee contracts and loan commitments.

Impairment model	Entities no longer apply an 'incurred' loss model. Entities determine impairment losses based on an 'expected' credit loss model. This means the following: An entity recognises an impairment loss (or reversal) in surplus or deficit, based on a change in the loss allowance (which is the adjustment to financial assets recognised in the statement of financial position). The loss allowance is based on weighted average expected credit losses, either over the lifetime of the instrument or 12-months from reporting date, with the respective risks of a default occurring as the weights. Credit losses are calculated as the present value of the difference between the cash flows due under a contract and the amount an entity expects to receive. A probability weighted assessment is used, which means there must be at least two scenarios in each calculation. <u>Step 1: Use lifetime or 12-month expected credit losses</u> The use of lifetime or 12 month expected losses depends on whether there has been a significant change in credit risk, i.e. change in risk of default occurring, since initial recognition (individual and collective assessment). An entity can assume there has been no significant change in credit risk if the instrument is of low credit risk. Lifetime losses reflect the possible occurrence(s) of default over the lifetime of the instrument. 12 month losses reflect the occurrence(s) of default over the 12 month period from reporting date. 12 month losses is <u>not</u> the lifetime losses apportioned over the 12 month period, <u>nor</u> is it the cash losses that will occur in the next 12 months. Significant change in credit risk (including those that are credit impaired on origination) = use lifetime expected credit losses. No significant change in credit risk = use 12 month expected credit losses. Rebuttable presumptions (unless reasonable and supportable information to indicate otherwise): • Credit risk increased significantly when contractual payments more than 30 days past due. • Default does not occur later than when a financial asset is 90 days past due. Default can be determined for an earlier timeframe – an entity should develop a specific policy in this regard.

	Step 2: Measure expected credit losses The expected cash flows are based on the lifetime or 12 month expected credit losses. The contractual period is the maximum period allowed. Expected credit losses are measured so that the following is reflected: • An unbiased and probability-weighted amount of credit losses is determined by evaluating a range of possible outcomes with the risk of default occurring as the weight. An entity must consider the possibility that a credit loss occurs, as well as the possibility that no credit loss occurs. • Time value of money. This is the effective interest rate is determined at initial recognition. Expected credit losses are determined based on reasonable and supportable information about past events, current conditions and forecasts of future economic conditions, that is available without undue cost or effort. Consider economic conditions of borrower as well as general economic conditions.
Presentation and disclosure requirements	GRAP 104 (2009) outlined requirements for when assets and liabilities can be offset, i.e.: A financial asset and a financial liability are only offset and the net amount presented in the statement of position when an entity: 1. Currently has a legally enforceable right to set-off the recognised amounts; and 2. Intends to settle on a net basis, or realise the asset and settle the liability simultaneously. GRAP 104 (2019) added guidance to explain what “legally enforceable right to set-off” means, i.e.: (a) The right of set off must not be contingent on a future event; (b) Must be legally enforceable in all of the following circumstances (of the entity and all counterparties): • Normal course of operations • Event of default • Event of insolvency or bankruptcy

	Additional disclosure requirements were introduced for concessionary loans issued by entities. Revised disclosures were introduced for the classification of financial instruments, as well as an entity's credit risk management practices, information that enables users to evaluate the effect of credit risk on the financial statements, and information about credit risk exposure.
	How to access information
Access information on the ASB and its work programme online	Visit our website on www.asb.co.za Follow us on Facebook and LinkedIn Subscribe to our Newsletter Access the translated versions of the Standards