Accounting Standards Board

Newsletter June 2023 Edition

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Message from the CEO – it's never too late to fall in love with Financial Instruments

When it comes to accounting topics, there are two that have me running for the hills – financial instruments and VAT. In a cruel twist of fate, I have either led or been involved in five financial instruments projects for the ASB and IPSASB over my professional career. And, when we started our most recent project on financial instruments, the first question we had to deal with was whether VAT is a financial instrument or not.

I am sure that many of you have the same feelings about financial instruments as I do. Admittedly, it is more complex than it should be because of tongue-tying terms (like fungible?) and that most complex transactions are not common to all public sector entities. However, instruments that all entities have in common are a bank account, payables, receivables, and perhaps and investment or two. So, financial instruments should be something that all public sector preparers and users understand on some level.

Financial instruments are "sector-neutral" transactions, which means that the nature and characteristics of the underlying transactions are the same in the public and private sector. Financial instruments are significant for many public sector entities, for example, municipalities that have large debtors books, investments and loans; and public entities that provide development finance.

The international standard applied in the private sector – IFRS 9 on *Financial Instruments* – was revised to respond to shortcomings in the financial statements during the financial crisis. As financial instruments are sector neutral transactions, the ASB Board adopted many of the changes in IFRS 9 when revising the Standard of GRAP on *Financial Instruments* (GRAP 104) in 2019.

The key changes to GRAP 104 are:

- Changes in the classification of instruments for subsequent measurement – financial assets are measured at either amortised cost or fair value based on the reason why they are held and their economic characteristics. Specific liabilities are measured at fair value, and all others are measured at amortised cost.

- The approach to impairing financial assets changed from an incurred loss to an expected loss model. As indicated in the name, expected losses estimate the expected default of financial assets over a period of time rather than only recognising an impairment loss when an event occurs.

- Loan commitments and financial guarantee contracts are recognised and measured differently. They are no longer in the scope of GRAP 19 on *Provisions, Contingent Liabilities and Contingent Assets*. When entering into these transactions there is an economic consequence that exposes an entity to risk. Accounting for them as financial instruments best captures this risk exposure.

- With the changes in the classification of instruments and impairment approach, there is new information that GRAP 104 requires entities to disclose.

The revised Standard will be effective for financial years commencing on or after 1 April 2025. The requirements of the Standard should be applied retrospectively, although some measurement principles and disclosure requirements should be applied prospectively.

Both the ASB Board and staff acknowledge the complexity of financial instruments. We will facilitate the adoption of GRAP 104 as far as our mandate allows by publishing helpful, easy to read information in Fact Sheets and FAQs. The objective of the Fact Sheets and FAQs is to make the principles in the Standard more accessible and simpler, particularly for entities with limited financial instrument transactions.

We also started a Financial Instrument Reference Group last year which is a group of technical experts and preparers that discuss potential application and implementation issues. The work of this group may result in new or amended Fact Sheets and FAQs being developed. Both the Auditor-General South Africa and National Treasury are part of this Group. As the work of the group progresses, we will communicate through our website, Newsletter and social media.

While 2025 might seem far away, it is not when aspects of the Standard need to be applied retrospectively. Retrospective application means that, where comparative information is required by the transitional provisions, opening balances or comparative data will be required for 1 April or 1 July 2024. This is only months away! Do not wait until 2025 to act – it will be too late!

"A difficult task can be done immediately, an impossible task requires a bit more time." George Santayana

PS: "Fungile" means replaceable by an identical item; typically used for commodities.

The Board is proposing revisions to GRAP 106 – your comment is sought

Background to the proposed revisions

The Board issued an Exposure Draft (ED 204) on *Proposed Revisions to the Standards of GRAP on Transfer of Functions Between Entities Under Common Control (GRAP 105), Transfer of Functions Between Entities Not Under Common Control (GRAP 106) and Mergers (GRAP 107).* ED 204 aligns the guidance in GRAP 105, GRAP 106 and GRAP 107 with IPSAS 40 on *Public Sector Combinations*. As the IFRS Accounting Standard on *Business Combinations* (IFRS 3) was used to develop parts of GRAP 106, ED 204 also proposes additional guidance from IFRS 3 that was issued after IPSAS 40 was approved.

The comment period for ED 204 closes on 15 July 2023.

The most significant changes proposed to GRAP 106

(a) Additional scope exclusion

The ED proposes an additional scope exclusion for the transfer of an investment entity as defined in GRAP 35 on *Consolidated Financial Statements.*

(b) Guidance on an optional test

ED 204 proposes to add guidance from IFRS 3 on an optional test (concentration test) in GRAP 106. This test allows an entity to apply a simplified assessment to decide if an acquired or received set of activities and assets and/or liabilities is not a function. An acquired or received set of activities and assets and/or liabilities is not a function if substantially all the carrying amounts of the gross assets acquired or received are concentrated in a single asset, or group of similar assets.

Illustrative examples are also included to illustrate the application of the optional test.

(c) Guidance to assess whether a transferred process is substantive

A function is an integrated set of activities and related assets and/or liabilities that are managed to achieve an entity's objectives by providing goods and/or services, or generating revenue. The ED proposes additional guidance from IFRS 3 to assess if an acquired or received process is substantive (and thereby would be a function) where the set of activities and assets and/or liabilities do not have

outputs. Although a function usually has outputs, outputs are not required for the activities, assets and/or liabilities to be a function.

Illustrative examples are included to illustrate the proposed guidance.

(d) Recognition principles for intangible assets

The ED proposes new guidance for intangible assets acquired or received that are not identifiable at the acquisition date. Examples include an assembled workforce and potential binding arrangements. The guidance clarifies that when an acquirer attributes value to the existence of an assembled workforce, it includes the value of the acquired or received intangible asset in the calculation of the resulting excess, rather than to account for the workforce separately as an identifiable intangible asset. Likewise, the acquirer includes any potential binding arrangements that the acquiree is negotiating at the acquisition date in the calculation of the resulting excess, as the binding arrangement itself does not qualify as an identifiable asset.

(e) Measurement principles

The ED proposes new measurement principles for:

- non-controlling interests in the acquiree. This guidance clarifies that the interest in the acquiree should be measured at its fair value at the acquisition date, using valuation techniques, unless a value can be obtained with reference to a quoted price in an active market; and
- assets that an acquirer intends not to use, or to use in a way that is different from the way other market participants would use them. The guidance clarifies that these assets should be measured at fair value and tested for impairment subsequently.

(f) Disclosure requirements

The ED proposes a new disclosure requirement for an acquirer to present the GRAP 106 disclosures if the acquisition date of the transfer of functions is after the end of the reporting period, but before the financial statements are authorised for issue. If the transfer of functions is incomplete when the financial statements are authorised for issue, information should be provided to explain which disclosures could not be presented, and the reason therefore.

What principles are retained in GRAP 106?

The Board agreed to retain the following principles in GRAP 106, thereby departing from the principles in IPSAS 40 or IFRS 3:

(a) *Measurement period*

The ED retains the two year measurement period that may be applied when the initial accounting for a transfer of functions is incomplete by the end of the reporting period in which the transfer occurs. IPSAS 40 allows a measurement period of one year.

From practical experience, the Board noted that entities locally need more time to obtain the necessary information to identify and measure the assets and/or liabilities in a transfer of functions.

(b) *Treatment of goodwill*

When the Board developed GRAP 106, it agreed to depart from the requirements in IFRS 3 on the treatment of goodwill. As in IFRS 3, IPSAS 40 refers to goodwill as the excess of the consideration transferred, any non-controlling interest in the acquiree and the net of the acquisition date fair values of the identifiable assets acquired or received and liabilities assumed.

In developing GRAP 106, the Board concluded that the excess is a premium paid by the acquirer to the previous owners. The Board also concluded that the definition of an asset or liability in the *Framework for the Preparation and Presentation of Financial Statements* is not met to support the recognition of goodwill.

In revising GRAP 106, the Board concluded that its reasons to depart from IFRS 3 remain relevant. The Board noted that even if the excess meets the definition of an asset, the entity may not be able to reliably measure it.

Do you agree with the proposed revisions to GRAP 106?

Share your thoughts by accessing the Exposure Draft on ED 204 – ASB, or by attending the roundtable discussion planned for the 4th of July 2023. If you are interested in joining this session, please contact amandab@asb.co.za.

The Board is proposing revisions to GRAP 107 on Mergers

Background to the proposed revisions

The Board issued ED 204 on *Proposed Revisions to the Standards of GRAP on Transfer of Functions Between Entities Under Common Control (GRAP 105), Transfer of Functions Between Entities Not Under Common Control (GRAP 106) and Mergers (GRAP 107)*. The ED primarily aligns the guidance in GRAP 105, GRAP 106 and GRAP 107 (the local Standards) with IPSAS 40 on *Public Sector Combinations*. IPSAS 40 classifies public sector combinations either as an amalgamation, or an acquisition.

The revision compared the amalgamation principles in IPSAS 40 to GRAP 107. The definition of an amalgamation in IPSAS 40 requires that no party gains control of one or more operations. This is similar to the principles for a merger in GRAP 107 which requires that no party acquires control, no acquirer can be identified and no party is seen to be dominant.

What changes are proposed to GRAP 107?

(a) Additional scope exclusions

The ED proposes additional scope exclusions for:

- the formation of a joint arrangement in the financial statements of the joint arrangement itself; and
- the transfer of an investment entity as defined in GRAP 35 on *Consolidated Financial Statements.*

(b) Additional exceptions to the recognition and measurement principles

Additional exceptions are proposed for:

- licences and similar rights previously granted by one combining entity to another, that are recognised as an intangible asset – the combined entity recognises and measures the intangible asset at its carrying amount, and tests it annually for impairment. An intangible asset granted for a finite period is amortised over the remaining period of the binding arrangement under which the right was granted.
- transfers, concessionary loans and similar benefits – the combined entity should not account for any revisions to a transfer or concessionary loan granted to a combining entity prior to the merger. Revisions are accounted for at the point that the grantor makes its intention known.

(c) Additional disclosures

The ED describes the composition of the combined entity's first set of financial statements following a merger. In addition, the following disclosures are proposed:

- for individually immaterial mergers that occurred during the reporting period that are material collectively, the disclosures in GRAP 107 should be presented;
- reasons why the initial accounting for a merger is incomplete where amounts have been determined provisionally, and the nature and amount of any measurement period adjustments; and
- for the combining entity, disclosures when the merger date is after the end of the reporting period but before the financial statements are authorised for issue.

Principles retained in GRAP 107

The Board agreed to retain the following principles in GRAP 107:

(a) Measurement period

The measurement period grants an entity additional time to account for a merger where the initial accounting is incomplete by the end of the reporting period in which the merger occurs. IPSAS 40 allows a measurement period of one year while GRAP 107 allows a two year period. The Board agreed to retain the two year measurement period as, from local experience, entities need more time to obtain the necessary information to identify and measure the assets and/or liabilities in a merger.

(b) Measurement principle

IPSAS 40 requires that the acquirer measures the acquired or received assets and/or liabilities at their carrying amounts. Prior to the transfer of the assets and/or liabilities, the transferor should adjust their

carrying amounts to conform to that of the acquirer. Adjustments also need to be made to eliminate transactions between the transferor and acquirer in calculating the excess.

To avoid additional costs to effect the merger, the Board agreed to retain the measurement principles in GRAP 107 which requires that the assets acquired or received, and/or liabilities assumed are measured at their carrying amounts. No adjustments need to be made to the carrying amounts prior to the merger, and no transactions between the combining entities need to be eliminated.

How can you comment on ED 204?

Share your comment on the proposed revisions to GRAP 107 with Amanda Botha at amandab@asb.co.za. Comment on ED 204 closes on 15 July 2023. The ED can be accessed on ED 204 – ASB.

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