South African Institute of Taxation

Time to phone a friend…?

A conversation about financial instruments

YOUR KEY TO THE TAX COMMUNITY

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Welcome

On the lunch plate today

1. **Tax focus points** touching on financial instruments
   a) Capital gains tax (CGT)
   b) S24J – interest
   c) Other

2. **Accounting focus points** touching on financial instruments (S11, S12 and S22 of IFRS for SMEs)
   a) **What are** financial instruments?
   b) How are financial instruments **initially recognised and measured**?
   c) How are financial instruments **subsequently measured**?
   d) How are financial assets **tested for impairment**?

3. Conclusionary remarks

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Tax focus points touching on financial instruments

Various provisions to consider

- ✓ Section 24J on interest
- ✓ Section 8E (dividends deemed to be interest) and section 8F (interest deemed to be dividends)
- ✓ Section 23M (Limitation of interest deductions)
- ✓ Dividend tax
- ✓ Exemption of income (section 10(1)(k), section 10(1)(i), section 10B)
- ✓ Withholding taxes and DTAs

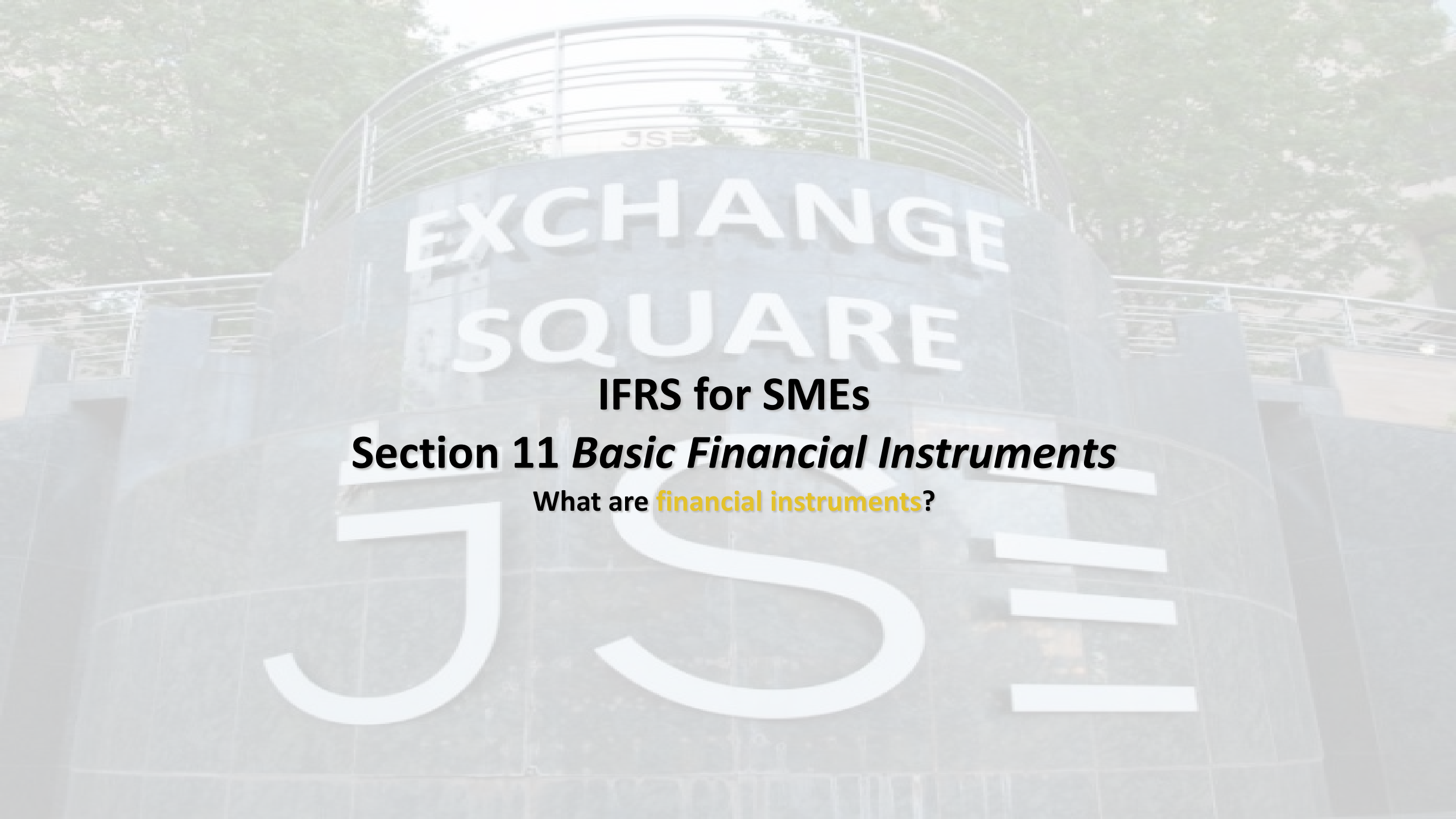
Accounting focus points touching on financial instruments

- ✓ Quite a complex topic for most accountants
  - ✓ Has been simplified over the years

- ✓ **Sections 11, 12 and 22** (IFRS for SMEs)
  - S11: Basic financial instruments
  - S12: Complex financial instruments
  - S22: Equity versus liabilities

- ✓ IFRS for SMEs much simpler than IFRS 9, but even IFRS 9 has been simplified
  - ✓ Impairment testing in IFRS 9 is more complex
  - ✓ May find itself into the IFRS for SMEs in 2023+

- ✓ Today's session, we break into components that may be relevant to tax practitioners



IFRS for SMEs

Section 11 *Basic Financial Instruments*

What are financial instruments?

Examples of financial instruments

- **WITHIN THE SCOPE OF SECTION 11 OF THE IFRS FOR SMEs**
  - Cash
  - Demand and fixed term deposits (entity is the depositor)
  - Commercial paper and commercial bills held
  - Trade receivables
  - Trade payables
  - Loans receivable
  - Loans payable
  - Bonds and similar debt instruments
  - Investments in non-convertible preference shares
  - Investments in non-puttable ordinary shares and preference shares
  - Commitments to receive a loan, where the commitment cannot be settled net in cash

Simple instruments!!

What is a financial instrument (FI)?

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- A contract (NB)
- That gives rise to a **financial asset** of one entity and
- A **financial liability** or **equity instrument** of another entity
- **Important to note:**
  - No contract, no financial instrument!
  - A financial instrument can be a **financial asset**, or a **financial liability**
  - An equity instrument, in itself, is not a financial instrument (e.g. a company's own ordinary shares)
  - Classification is very important!

The main categories of FI's

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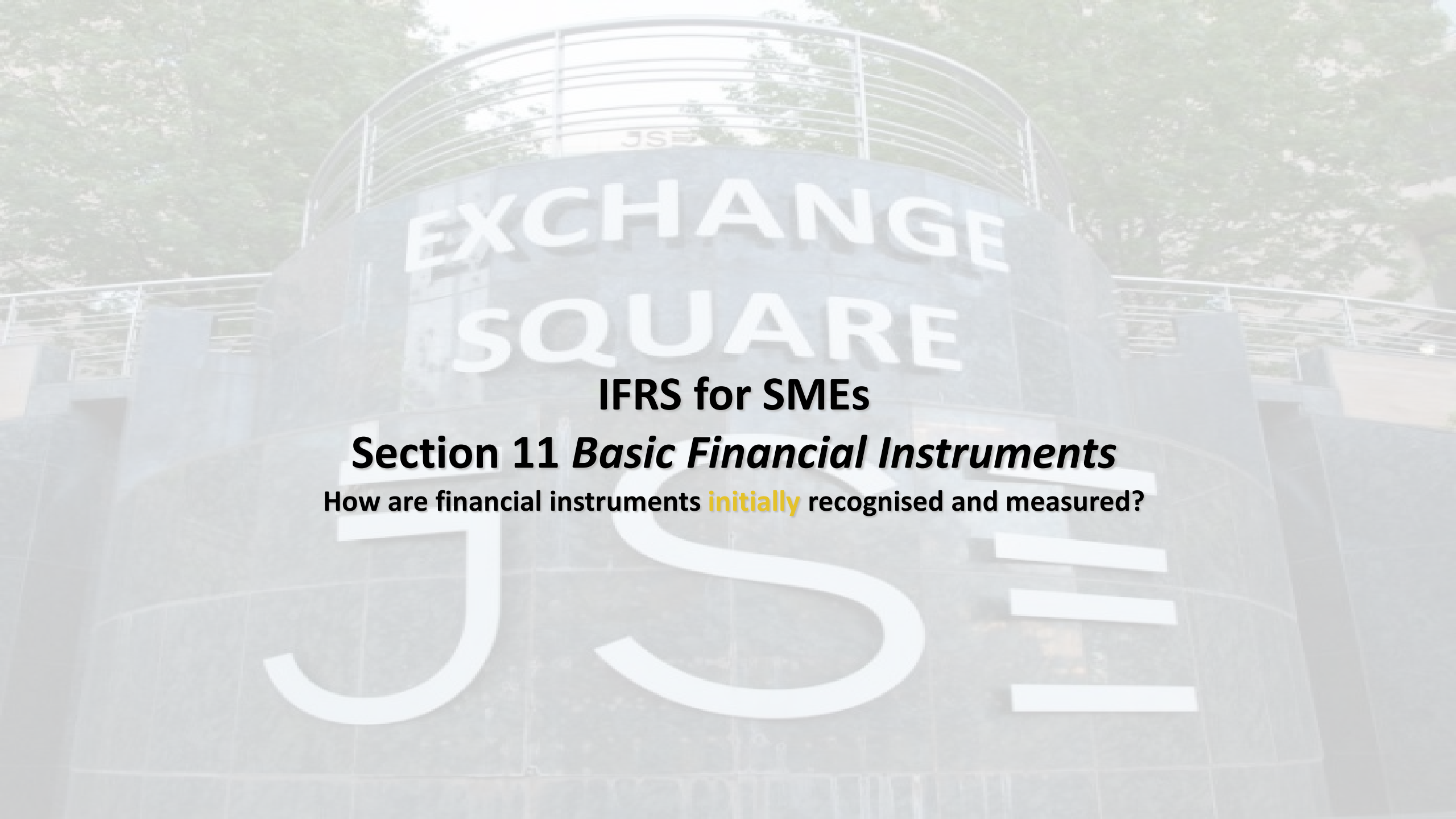
4 MAIN CATEGORIES OF FINANCIAL INSTRUMENTS

- (a) **Cash**
- (b) A **debt instrument** (e.g. trade receivables, bonds and loans payable/receivable, redeemable instruments etc.)
- (c) A **commitment** to receive a loan that:
  - (i) cannot be settled NET in cash (i.e. speculation not possible); and
  - (ii) when the commitment is executed, is expected to meet certain prescribed conditions
- (d) An **investment in non-convertible preference shares** and **non-puttable ordinary shares or preference shares**



IFRS for SMEs

Section 11 *Basic Financial Instruments*

How are financial instruments initially recognised and measured?

Initial recognition – when?

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- Financial assets (FA's) or financial liabilities (FL's) shall be initially recognised ONLY when the entity becomes a party to the contractual provisions of the instrument

- Legal form prevails…

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Initial measurement

- When a FA or FL is recognised initially (i.e. at FIRST recognition), the entity shall measure the FI at its **transaction price**
  - Transaction costs are usually included in the transaction price…
  - If the FA or FL is subsequently measured at fair value through profit or loss, the transaction costs are expensed at initial recognition through profit or loss
- If the arrangement/agreement, in effect, constitutes a financing transaction, the FA or FL shall be measured at the **present value of the future payments** discounted at a market rate of interest for similar debt
  - This is normally evident in:
    - Interest-free financing
    - Financing below market-related terms

Most FI's i.t.o. IFRS for SMEs will initially be measured at the transaction price

Thoughts on initial measurement

- Initial measurement is interesting ☺
- Goal is to ensure **initial measurement at an appropriate amount**, which is market-related
- *If transaction is based on 'arm's length' terms, the **transaction price** will approximate the **fair value** of the financial instrument (FA or FL)*
- Therefore always compare transaction terms with market terms!!

Possibility 1: Sales/purchase transactions with 'implicit' financing element

Possibility 2: Other debt instruments – interest below market-related rates

Example 1: Initial measurement

- Company GHI (Pty) Ltd obtains a long-term loan from ZZZ Bank of R3 million. Interest of 9.5% per annum (nominal and pre-tax) is compounded and paid annually. The loan's capital will be paid back at the end of the 5 year term of the agreement. Similar loans bear interest at 9.5% per annum, nominal and pre-tax

- *It is evident that there is no sign of:*
  - *An 'implicit' financing element (this is not a sales/purchase transaction)*
  - *Interest below market-related rates*

- The loan will therefore be initially measured by GHI (Pty) Ltd **at the transaction price of R3 million**
- *(Test: Discounting future cash flows (interest and capital) will return a present value of R3 million, as the loan's terms are the same as the market-related terms)*

Example 2: Initial measurement

- Parent A grants a loan of R2 million to subsidiary B. The loan is repayable at the end of 5 years and bears nominal interest of 5% per annum, pre-tax. Interest is compounded and paid annually. Loans to entities with a **similar** risk profile to that of entity B, bear market-related interest at 10% per annum, nominal and pre-tax

- *It is evident that there is an **effective financing transaction** present as the subsidiary and the parent are related parties and the interest rate on the loan is 5% below the market interest rate*

- The loan will be **initially** measured at the **present value of the expected cash flows**, as it constitutes an effective financing arrangement…

- FV = R2 million (redemption amount)
- Pmt = 5% x R2 million = R100 000 interest paid annually
- I/Yr = 10% (market-related)
- N = 5 (term of loan in years)
- P/Yr = 1 (compounded annually)
- Thus PV = R1 620 921 (rounded)
- The loan will be initially measured at **R1 620 921**

Journal entry in Parent's books:

Dr Loan receivable	1 620 921	
Dr Loss (P/L)	379 079	
Cr Bank		2 000 000

Example 3: Initial measurement

- Purchase or sales transaction = risk of 'implicit' financing element!
- Company A sells goods to the value of R25 000 (excluding VAT) to customer X on credit. Customer X is granted 90 days, which is the **standard credit period** for all customers, to settle the debt. The prime rate of interest is 10% per annum, nominal and pre-tax.
- The debtor (financial asset) that is recognised by company A is measured **initially** at the transaction price. As the debt is within the normal credit terms of the company and also short-term (3 months), the amount will be left undiscounted. There is no evidence of an 'implicit' financing element present…
- Trade debtor initially measured at R28 750 (including VAT) – this is **the transaction price**!

Example 4: Initial measurement

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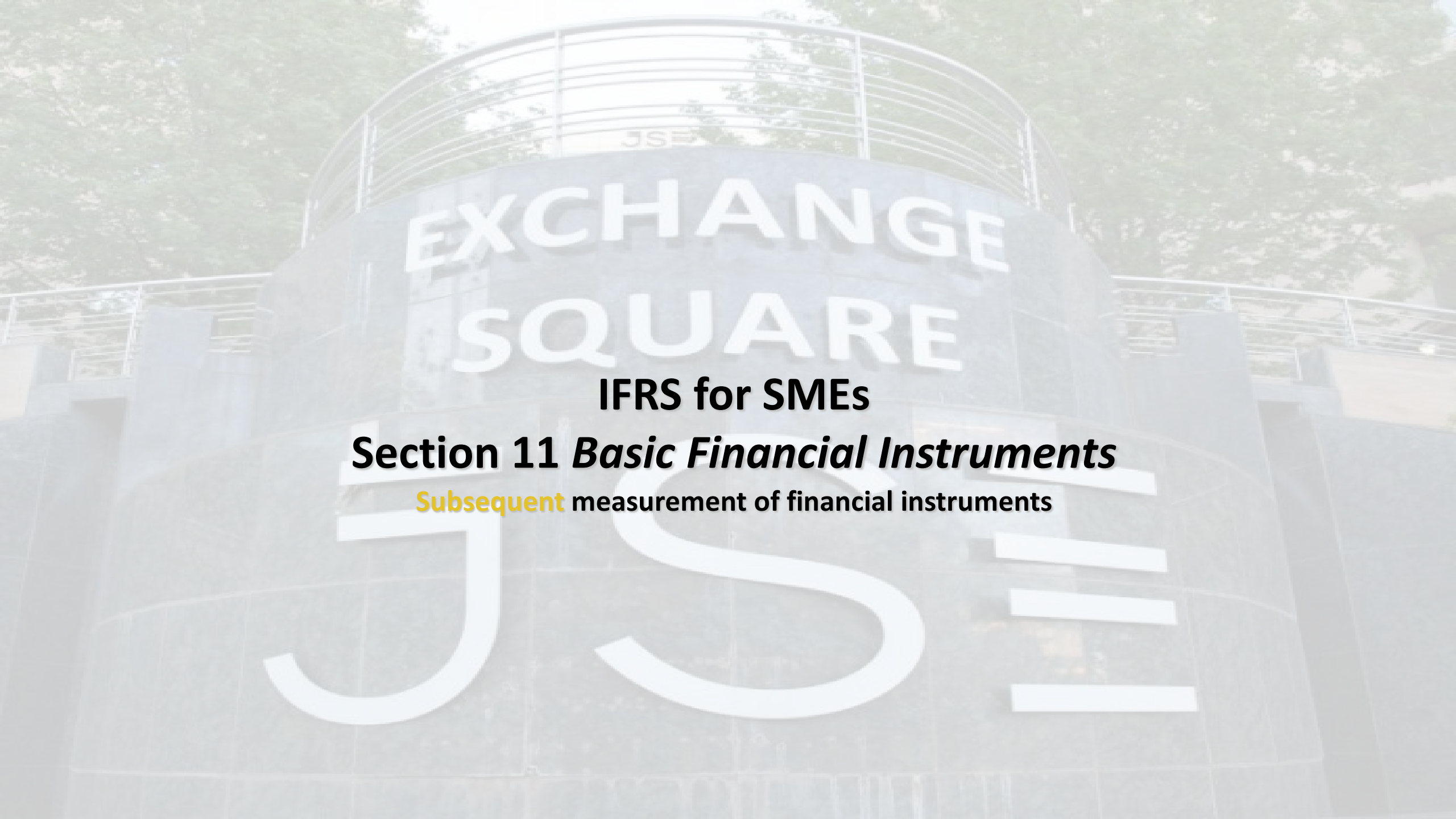
- Purchase or sales transaction = risk of 'implicit' financing element!
- Company B sells goods to Customer Z for R2 million on credit and **charges no interest**. Customer Z is granted 12 months to settle the debt. The credit terms **exceed the normal credit terms** of company B. The applicable interest rate is 10% per annum, nominal and pre-tax in respect of similar customers.
- The debtor (financial asset) that is recognised by company B is measured **initially** at the present value of the expected cash flows as it constitutes an effective financing arrangement (there is an 'implicit' financing element present)
- The trade debtor will be initially measured at the **current cash price of the item**, or if that price is not available, the **present value of the future cash flows discounted at a market-related interest rate** (e.g. 10% per annum)



IFRS for SMEs

Section 11 *Basic Financial Instruments*

Subsequent measurement of financial instruments

Subsequent measurement of FI's

- Debt instruments that satisfy prescribed conditions
  - **Amortised cost**, using the effective interest method
- Debt instruments classified as *current assets* or *current liabilities*
  - **Undiscounted** amount of cash or other consideration expected to be paid or received, net of impairment where appropriate
  - Unless the arrangement constitutes a financing transaction: **PV of future payments** discounted at a market-related interest rate for similar debt instrument
- Commitments to receive a loan: **at cost**, which could be zero
- Investments in non-convertible preference shares or non-puttable ordinary or preference shares:
  - If traded publicly or fair value can be reliably measured: **@FVTPL**
  - Otherwise at **cost less impairment**

Effective interest method?

- Affected by discounts, premiums and transaction costs
- The nominal interest rate is not (necessarily) the interest recognised in profit or loss…
- Effective interest takes into account ALLOCATION of items such as transaction costs, discounts/premiums at acquisition, discounts/premiums at redemption and effectively 'smoothes' them over the term of the instrument

- This is also why the prescribed conditions are important in respect of limiting uncertainty and contingencies and fixing returns (rates and amounts)
- Remember: Section 24J of the Income Tax Act refers to **effective** interest, not nominal interest…

Example: amortised cost

- Company DEF (Pty) Ltd issues bonds and receives R2 million in cash on 1/1/2022. The bonds bear interest at 12% per annum (nominal and pre-tax) and are redeemable at R2.2 million (i.e. R200 000 premium) at maturity date, being 31/12/2026 (i.e. 5 years). Interest receivable is compounded and received annually at the end of the year. Similar bonds in the market bear interest at 12% per annum, nominal and pre-tax. Transaction costs amount to R50 000 and are paid in cash on 1/1/2022.

- The bonds are **debt instruments** that satisfy prescribed conditions:
  - Returns: fixed amount, fixed rate
  - No contractual provision that determines that company DEF can lose principle or interest for any current or prior period(s)
  - No contingent prepayment provisions for holder or issuer
  - No conditional returns (not even interest rate is variable)

- Bond will be subsequently measured at amortised cost, using **effective interest method**

Example (continued)

- The effective interest rate must be calculated first
  - PV = R2 million less R50 000 transaction costs = R1 950 000 net inflow
  - N = 5 years
  - P/Yr = 1 (compounded once per annum)
  - Pmt = (R240 000) (i.e. R2 million x 12%)
  - FV = (R2.2 million) (redemption amount)
  - Thus: effective I% = **14.24%**

- **Why not 12%?**
  - Transaction costs reduce net cash inflow by R50 000
  - Redemption premium not reflected in the 12% annual interest

Example (continued)

- Journal entries

1/1/2022 (initial recognition and measurement)		
Dr Bank	R2 000 000	
Cr Bond liability		R2 000 000
(recognise bond issued)		
Dr Bond liability	R50 000	
Cr Bank		R50 000
(capitalise transaction costs to bond)		
31/12/2022 (subsequent measurement)		
Dr Interest expense (P/L)	R277 680	
Cr Bank		R240 000
Cr Bond liability (bal. figure)		R37 680
(recognise interest at effective rate of 14.24% p.a. on R1.95 million)		

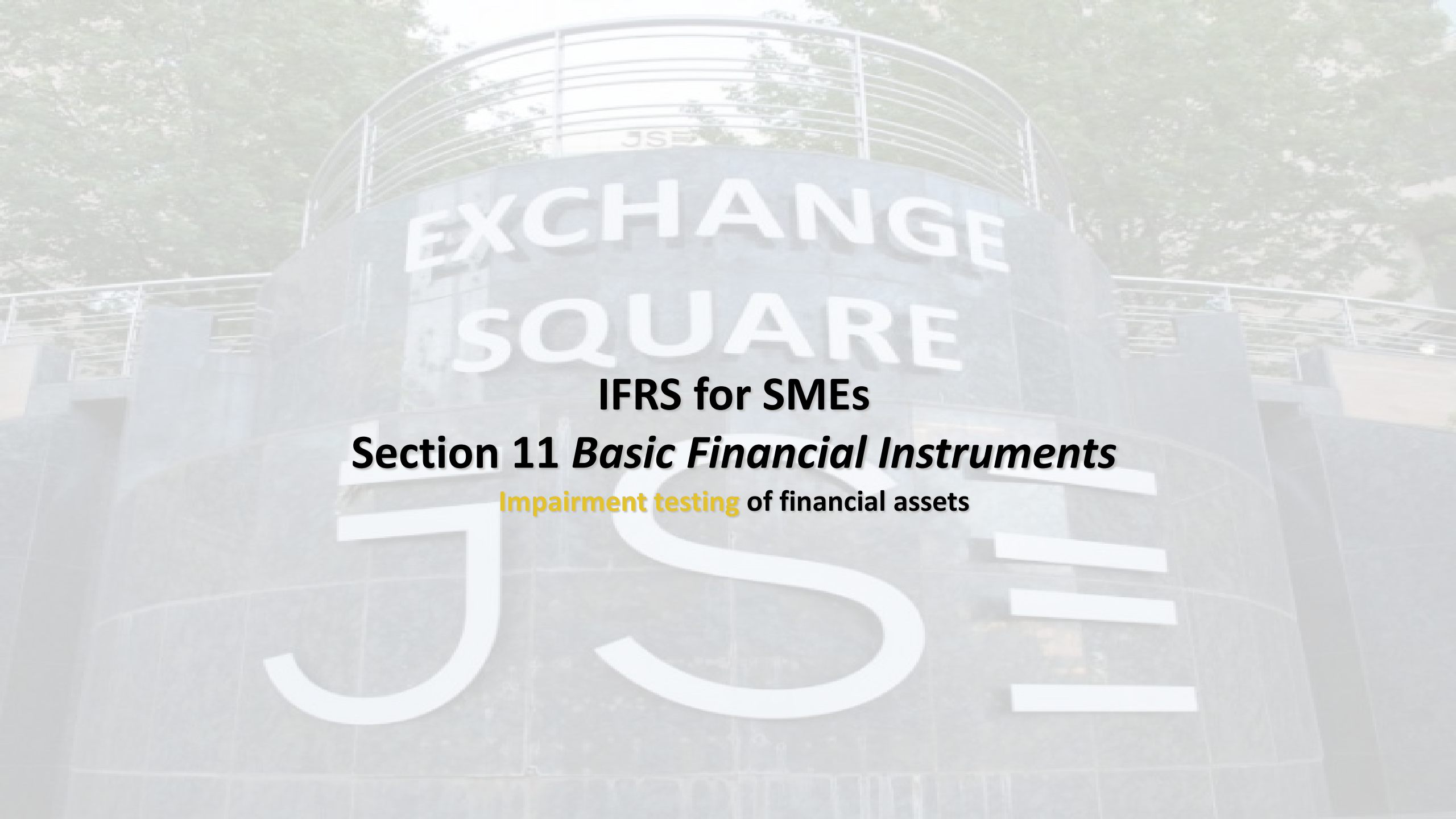
Transaction price

S24J

Example (continued)

- Journal entries

31/12/2023		
Dr Interest expense (P/L)	R283 046	
Cr Bank		R240 000
Cr Bond liability (bal. figure)		R43 046
(recognise interest at effective rate of 14.24% p.a.)		
31/12/2024		
Dr Interest expense (P/L)	R289 175	
Cr Bank		R240 000
Cr Bond liability (bal. figure)		R49 175
(recognise interest at effective rate of 14.24% p.a.)		
31/12/2025		
Dr Interest expense (P/L)	R296 178	
Cr Bank		R240 000
Cr Bond liability (bal. figure)		R56 178
(recognise interest at effective rate of 14.24% p.a.)		
31/12/2025		
Dr Interest expense (P/L)	R304 178	
Cr Bank		R240 000
Cr Bond liability (bal. figure)		R64 178
(recognise interest at effective rate of 14.24% p.a.)		
Dr Bond liability	R2 200 000	
Cr Bank		R2 200 000
(settlement of bond liability)		



IFRS for SMEs

Section 11 *Basic Financial Instruments*

Impairment testing of financial assets

Impairment testing of FA's

- How is the impairment loss measured?

  - FA's measured at amortised cost:
    - IL = CA of FA less PV of estimated cash flows discounted at the FA's **original** effective interest rate

  - FA's measured at cost less impairment:
    - IL = CA of FA less best estimate of amount receivable should the FA be **sold** at reporting date (amount is an approximation, could be zero)

Example of impairment of FA's

- Company A (Pty) Ltd invested in bonds for R5 million with a term of 5 years. The bonds bear coupon interest at 10% p.a. (nominal and pre-tax). Similar bonds also bear coupon interest at 10% p.a. (nominal and pre-tax). The bonds will be redeemed at the end of 5 years (31/12/2026) at a premium of 10% on their par value of R5 million. Interest is calculated and paid annually.

- Step 1: Calculate effective rate of the FA:
  - PV = (R5m) cash outflow
  - FV = R5.5m cash inflow at redemption
  - N = 5 years
  - P/Yr = 1 (compounded annually)
  - Pmt = R500 000 (i.e. 10% x R5m)
  - Thus I/Yr = **11.59%**

Example (continued)

- Step 2: Journalise the transaction in the records of Company A (Pty) Ltd:

1/1/2022		
Dr Investment in bonds	R5 000 000	
Cr Bank		R5 000 000
31/12/2022		
Dr Bank	R500 000	
Dr Investment in bonds (bal. figure)	R79 353	
Cr Interest received (P/L)		R579 353 S24J
31/12/2023		
Dr Bank	R500 000	
Dr Investment in bonds (bal. figure)	R88 548	
Cr Interest received (P/L)		R588 548 S24J

Example (continued)

- Assume at the end of year 2024, objective evidence exists that the holder of the bonds is experiencing financial difficulty and cannot make further coupon payments for two years (being 2024 and 2025). The coupon payments will then be made at R600 000 for the years ending 2026, 2027 and 2028. The bonds will now be redeemed at R5 million + 10% on their par value on 31/12/2028.

- **What is the impairment loss on the bonds?**
  - Step 1: Calculate the PV of the expected future cash flows as at 31/12/2024
    - CF1 (2024) and CF2 (2025) = 0
    - CF3 (2026) and CF4 (2027) = R600 000
    - CF5 (2028) = R6.1 million (being R5.5 million + R600 000)
    - **I/Yr = 11.59 (the original effective interest rate)**
    - Thus new PV = R4 344 636

Example (continued)

- Step 2: Calculate the CA of the FA as at 31/12/2024:
  - R5m (Jnl 1) + R79 353 (Jnl 2) + R88 548 (Jnl 3) + R598 808 = **R5 766 709**

- Step 3: Compare CA (step 2) to recoverable amount (step 1)
  - R5 766 709 – R4 344 636 = R1 422 073 265 (impairment loss)
  - Journal entry:
    - Dr Impairment loss (P/L) R1 422 073
    - Cr Investment in bonds (F/P) R1 422 073

    Or

    - *Cr Allowance for impairment (F/P) R1 422 073*
    - *(recognise impairment loss on FA measured at amortised cost)*

Example (continued)

- Journal entries for 2024 to 2028 (with revised cash flows and revised term)

31/12/2024 (no cash payment of interest by holder)		
Dr Investment in bonds	R503 416	
Cr Interest received (P/L)		R503 416
31/12/2025 (no cash payment of interest by holder)		
Dr Investment in bonds	R561 747	
Cr Interest received (P/L)		R561 747
31/12/2026 (cash interest payments commence by holder)		
Dr Bank	R600 000	
Dr Investment in bonds	R26 837	
Cr Interest received (P/L)		R626 837
31/12/2027		
Dr Bank	R600 000	
Dr Investment in bonds	R29 947	
Cr Interest received (P/L)		R629 947
31/12/2028		
Dr Bank	R600 000	
Dr Investment in bonds	R33 417	
Cr Interest received (P/L)		R633 417
Dr Bank	R5 500 000	
Cr Investment in bonds		R5 500 000

FA's measured at fair value

- Investments in ordinary (equity) shares or preference shares must be **measured at fair value**, if they are publicly traded **or** their fair values can be measured reliably *(i.e. it is not a choice, it is a requirement!!)*
  - If both not applicable, then at cost less impairment…
- Fair value hierarchy, to determine fair value, is as follows:
  - **Quoted price** for an identical asset in an active market (usually the current bid price)
  - If quoted prices are unavailable, the price of **recent transaction** for an identical asset (as long as no significant changes have taken place in economic circumstances or no significant time lapse)
  - If the market is not active and recent transactions of an identical asset are not a good estimate of fair value, the entity estimates fair value by using a **valuation technique**

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