

Financial Instruments

IPSAS 41

Guideline

September 2023

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1. Introduction

The International Public Sector Accounting Standard (IPSAS) 41, Financial Instruments was issued in August 2018 by the International Public Sector Accounting Standards Board (IPSASB) to replace IPSAS 29, Financial Instruments: Recognition and Measurement. It also amends IPSAS 28, Financial Instruments: Presentation, and IPSAS 30 Financial Instruments: Disclosures.

IPSAS 41 is applicable in annual reporting periods beginning on or after January 1, 2023. It is applicable to entities reporting under IPSAS Accrual. For entities who adopt IPSAS Accrual for the first time subsequent to the effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption of IPSAS Accrual.

To maintain convergence with International Financial Reporting Standards, IPSAS 41 is based on the International Financial Reporting Standard (IFRS) 9, Financial Instruments, developed by the International Accounting Standards Board (IASB).

The objective of IPSAS 41 is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing, and uncertainty of an entity's future cash flows.

2. Scope of IPSAS 41

IPSAS 41 establishes new requirements for classifying, recognizing and measuring financial instruments.

What is new?

- A single classification and measurement model for financial assets that considers the characteristics of the asset's cash flows and the objective for which the asset is held.
- A forward-looking expected credit loss model that is applicable to all financial instruments subject to impairment testing.
- A hedge accounting model that broadens the hedging arrangements in the scope of the guidance. The model develops a strong link between an entity's risk management strategies and the accounting treatment for instruments held as part of the risk management strategy.

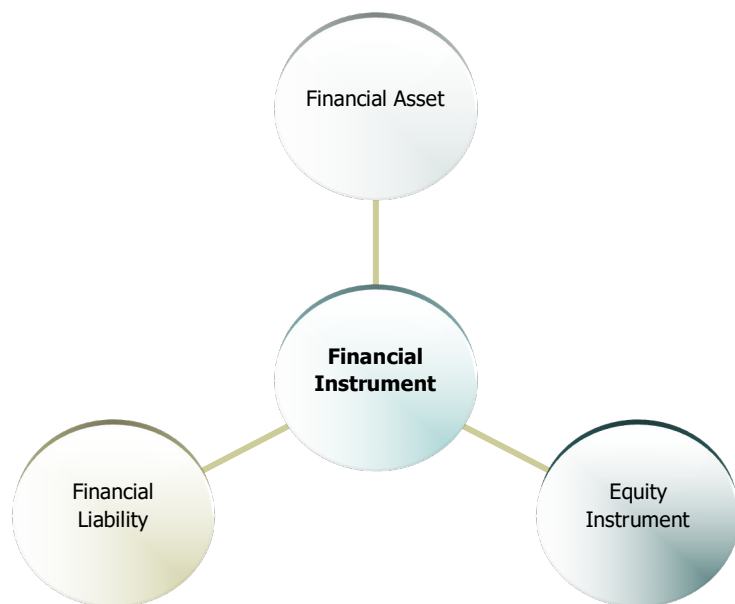
The standard additionally gives public sector-specific considerations and includes additional public sector-specific examples and guidance on how to apply the principles. Additional Public sector guidance included relates to:

- i. Concessionary loans
- ii. Equity instruments from non-exchange transactions
- iii. Fair value measurement considerations

Definition of terms

i. Financial instruments

These are contracts that give rise to both a financial asset in one entity and a financial liability or an equity instrument in another.



ii. Financial assets

This is cash, an equity instrument of another entity, or a contract to receive cash at a future date.

Examples of financial assets include:

- Cash held with financial institutions (Current account, fixed account, call deposits etc.)
- Accounts receivables
- Loans receivable, including concessionary loans.
- Investments securities (Treasury Bills, Treasury bonds)
- Investments in ordinary shares of another entity etc.

Note: Statutory receivables and Prepayments are not financial assets

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iii. Financial liabilities

These are contractual obligations to deliver cash or another financial asset to another entity.

Examples of financial liabilities include:

- Bank overdrafts
- Accounts payable
- Borrowings (loans from financial institutions and concessionary loans) etc.

iv. Equity instruments

Equity instruments represent an interest in the net assets of another entity. Equity instruments are often common shares or other types of investment in another entity.

Example: Financial Instruments

A Public Hospital offers medical services to students from a public high school on credit. At the end of the year, the Public high school owed the public hospital KES 1.5 million for the medical services provided.

The Public hospital will report a gross medical service receivable of KES 1.5 million as a financial asset while the public high school will report a gross medical service payable as a financial liability.

Financial asset: Medical service receivable

3. Recognition and Measurement

Initial recognition

An entity shall recognize a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument.

A financial instrument is derecognized using trade date accounting or settlement date.

Derecognition

Derecognition of Financial Assets

An entity shall derecognize a financial asset when, and only when:

- a) The contractual rights to the cash flows from the financial asset expire or are waived.

Example: *When account receivables are paid off, when investments securities mature, when loan receivables are waived off etc.*

- b) It transfers the financial asset. An entity transfers a financial asset only if it either:
 - i. Transfers the contractual rights to receive the cash flows of the financial asset, or
 - ii. Retains the contractual rights to receive the cash flows of the financial asset (original assets) but assumes a contractual obligation to pay those cash flows to one or more recipients in an arrangement that meets the set conditions. This transaction is treated as a transfer only if these 3 conditions are met.
 - The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset.
 - The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
 - The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.

If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset.

- a) If the entity has not retained control, it shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.
- b) If the entity has retained control, it shall continue to recognize the financial asset to the extent of its continuing involvement in the financial asset.

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On the derecognition of a financial asset, the difference between the carrying amount and the consideration received is recognized in surplus and deficit.

Derecognition of Financial liabilities

An entity shall remove a financial liability from its statement of financial position when it is extinguished—i.e., discharged, waived, canceled or expires.

A financial liability is extinguished when the debtor either:

- a) Pays the creditor, normally with cash, other financial assets, goods or services; or
- b) Is legally released from primary responsibility for the liability either by process of law or by the creditor.

Other Circumstances Resulting to Derecognition

- 1. An exchange between an existing borrower and lender of debt instruments with substantially different terms.
- 2. A substantial modification of the terms of the existing financial liability.

Substantially different: The terms are substantially different if the present value of the cash flows under the new terms (including any fees paid net of any fees received) when discounted using the original effective interest rate is at least 10% different from the present value of the remaining cash flows of the original financial liability.

These two circumstances above are accounted for by derecognizing the original financial liability and recognizing a new financial liability.

On derecognition, the difference between the carrying amount of a financial liability extinguished or transferred to another party and the consideration paid (including any non-cash assets transferred or liabilities assumed) is recognized in surplus or deficit.

N/B: Where the terms are not substantially different the original liability is not derecognized. The liability is restated to the present value of the revised cash flows. Any increase or decrease in the carrying amount is presented in the statement of surplus and deficit.

Classification

Classification of Financial Assets

An entity shall classify its financial assets into either subsequently measured at:

- a) Amortized cost
- b) Fair value through surplus or deficit (FVTSD)
- c) Fair value through net assets/equity (FVNAE)

IPSAS 41 applies one approach for classification of all financial assets. Classification of financial assets is based on these 2 criteria:

- i. The entity's management model for financial assets
- ii. The contractual cash flow characteristics of the financial asset.

I. Management Model for financial assets

An entity's management model refers to how an entity manages its financial assets in order to generate cash flows. An entity can have either of the 3 management models for its financial assets:

- i. A management model whose objective is to hold financial assets in order to collect contractual cash flows. Under this model:
 - Financial assets held to collect contractual cash flows over the life of the instrument.
 - The entity need not hold all of those instruments until maturity i.e., Sales may occur, however they are sales incidental to the business model objective. The frequency and value of sales are normally low. Sales occur close to the maturity of the instruments and are not expected to continue in the future.
- ii. A management model whose objective is achieved by both collecting contractual cash flows and selling financial assets.
 - Both collecting contractual cash flows and selling financial assets are integral to achieving the objective of the management model of the financial asset.
 - Typically involve greater frequency and value of sales compared to the held to collect model.
- iii. Other management models other than i & ii above.
 - For example, an entity manages the financial assets with the objective of realizing cash flows through active buying and selling of the assets.

- Collection of contractual cash flows is not integral to achieving the management model's objective; instead, it is incidental to it.

Considerations when determining the management model for financial assets.

- An entity's management model for financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the management model.
- The management model is determined at a portfolio level and not at individual instrument level i.e. It is determined at a level that reflects how groups of financial assets are managed together to achieve a particular objective.
- A single entity may have more than one management model for its financial instruments.

For example, an entity could have Treasury bills that it manages in order to collect contractual cash flows and Treasury bonds that it manages in order to trade to realize gains in fair value changes.

II. Contractual cash flow characteristics of the financial asset.

To determine the classification of a financial asset an entity needs to review whether contractual cashflows are solely payments of principal and interest on the principal amount outstanding.

An entity reviews the cashflow coming from the asset and check if they are consistent with basic lending arrangement which include payments for principal and interest.

Principal: is the fair value of the financial asset at initial recognition. The amount may change over the life of the financial asset (for example, if there are repayments of principal).

Interest: is the consideration of the time value of money and credit risk. It can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time.

Considerations when analyzing the cashflow characteristics of financial assets.

- Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Derivatives such as stand-alone option, forward and swap contracts are leveraged in nature.
- Debt instruments that do not meet the cashflow characteristic tests cannot be subsequently measured at amortized cost or fair value through net assets/equity.

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- I. The financial asset is held within a management model whose objective is to hold financial assets in order to collect contractual cash flows and
- II. The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

- Financial assets classified as measured at amortized cost are subject to impairment testing.
- Equity instruments and derivatives cannot be classified as measured at amortised cost as the cashflows are not solely payments of principal and interest.

b) Fair Value through net assets/equity

A financial asset shall be measured at fair value through net assets/equity if both of the following conditions are met:

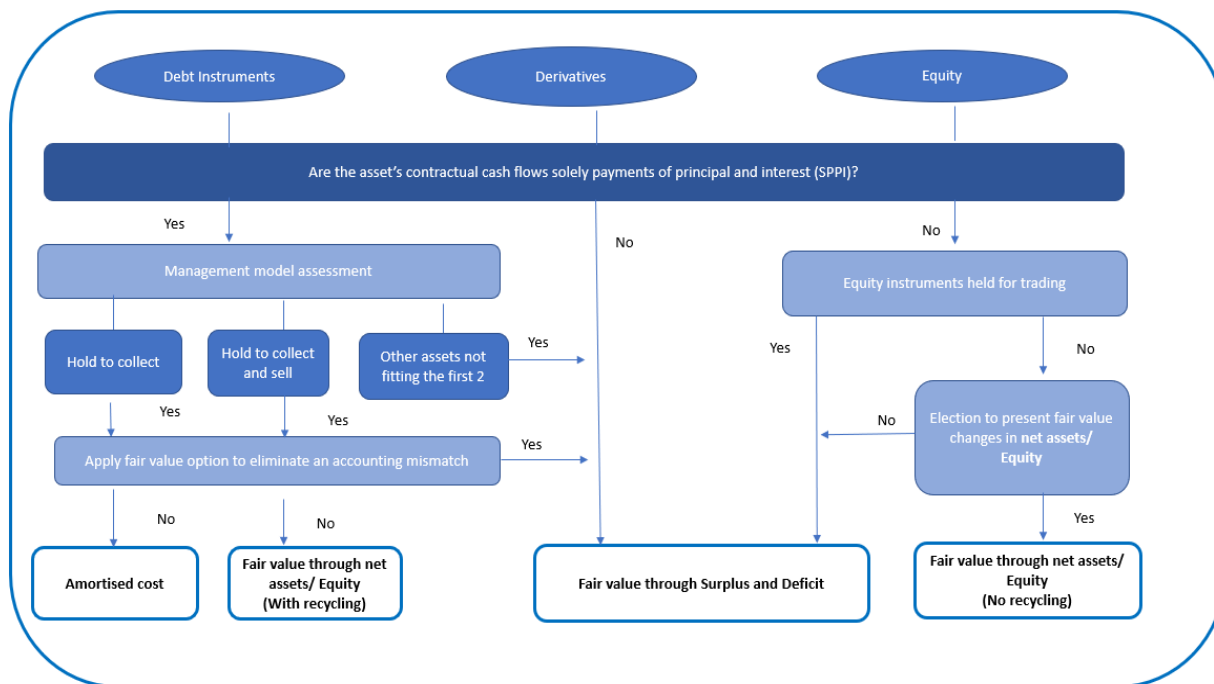
- I. The financial asset is held within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets and
- II. The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

- An entity may elect to classify equity instruments not held for trading as measured at fair value through net assets/equity. The election is irrevocable.
- On disposal of the equity instrument, gains or losses presented in net assets/equity shall not be subsequently transferred to surplus or deficit (No recycling)

c) Fair Value through surplus or deficit

A financial asset shall be measured at fair value through surplus or deficit unless it is measured at amortized cost or at fair value through net assets/equity.

A financial asset that would qualify to be measured at amortized cost/ at fair value through net assets/equity can be classified as measured at fair value through surplus or deficit if doing so eliminates an accounting mismatch.



Classification of Financial Liabilities

An entity classifies all financial liabilities as subsequently measured at amortized costs, except for:

- Financial liabilities at fair value through surplus or deficit e.g., derivatives
- Financial liabilities that arise when a transfer of a financial assets does not qualify for derecognition.
- Financial guarantee contracts
- Commitment to provide a loan at a below market interest rate.
- Contingent consideration recognized by an acquirer in a public sector combination.

An entity may, at initial recognition, designate a financial liability as measured at fair value through surplus or deficit. The decision is however irrevocable i.e., cannot be changed thereafter.

Reclassification

Is an entity allowed to reclassify financial assets from one classification option to another?

Yes, on condition that the entity changes its management model for managing financial assets.

- Reclassification should be applied prospectively from the reclassification date. The entity should not restate any previously recognized gains, losses or interest already recognized.
- Reclassification of Investments in equity classified as measured at Fair value through net assets is not allowed.

Is an entity allowed to reclassify financial liabilities from one classification option to another?

No, Reclassification of financial liabilities is not allowed.


Accounting for reclassification of a financial asset

Amortized Cost → **FVTSD**

- Determine Fair value at the reclassification date.
- Gains or losses between the carrying amount and the fair value recognised in Surplus and Deficit.

Amortized Cost → **FVNAE**

- Determine Fair value at the reclassification date.
- Gains or losses between the carrying amount and the fair value recognized in net assets/equity.
- Derecognise a loss allowance from gross carrying amount and recognise same amount as an accumulated impairment amount in net assets/equity.

FVTSD  **Amortized Cost**

- The fair value at the reclassification date becomes the new carrying amount.
- Recognize a loss allowance as an adjustment to the gross carrying amount of the financial asset.

FVNAE  **FVTSD**

- Financial asset continues to be measured at fair value.
- Reclassify cumulative gain or loss from net assets/equity to surplus or deficit.

FVTSD  **FVNAE**

- Financial asset continues to be measured at fair value.

Measurement

Initial measurement

All financial assets and liabilities are initially recognized at fair value except for short-term receivables and payables that are recognized at the original invoice amount if the effect of discounting is immaterial.

Fair value: Is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The fair value of a financial instrument at initial recognition is normally the transaction price.

Transaction costs at initial recognition

At initial recognition transaction costs directly attributable to the acquisition or issue are deducted or added to the fair value of the financial asset or financial liability except for those classified and measured at fair value through surplus or deficit.

What happens if the fair value at initial recognition differs from transaction price?

- If the fair value has been determined using level 1(Quoted prices) or level 2 inputs (Observable inputs), recognize the difference as a gain or loss.
- If Fair value is determined using other means e.g., level 3 inputs, differ the difference and only recognize that deferred difference as a gain or loss only to the extent that it arises from a change in a factor that market participants would consider when pricing the asset or liability.

Concessionary Loans

Concessionary loans are granted to or received by an entity at below market terms.

Examples: *loans to developing countries from development agencies, student loans granted to university students by government entities, housing loans granted to low-income families from government entities etc.*

To account for a concessionary loan an entity determines the fair value of the loan.

On initial recognition the transaction price for a concessionary loan may not be its fair value. The difference between the Fair value of the loan and the transaction price is accounted for as follows:

- The entity receiving the concessionary loan accounts for the difference as follows:
 - Immediately as revenue from non-exchange transactions in accordance with IPSAS 23, if the was granted with no conditions.
 - If the loan was granted with conditions, the difference is booked as a liability and recognized as revenue from non-exchange transactions as the entity meets the conditions.
- The entity granting the concessionary loan accounts for the difference as follows:
 - As an expense in surplus or deficit at initial recognition, except where the loan is a transaction with owners, in their capacity as owners.
 - Where the loan is a transaction with owners in their capacity as owners, for example, where a controlling entity provides a concessionary loan to a controlled entity, the difference is accounted for as a capital contribution, i.e., an investment in an entity.

Subsequent measurement of financial assets

An entity shall subsequently measure a financial asset in accordance with how it is classified i.e. either

- a) Amortized cost
- b) Fair value through net assets/equity; or
- c) Fair value through surplus or deficit

a. Amortized cost Measurement

Interest revenue

Interest revenue shall be calculated by using the effective interest method.

Financial asset:	Not Impaired	Credit Impaired	Credit impaired	Purchased/originated credit-impaired
Interest rate:	Effective interest rate	Effective interest rate	Effective interest rate	Credit-adjusted effective interest rate
Amount applied on	Gross carrying amount	Gross carrying amount	Amortized cost of the financial asset	Amortized cost of the financial asset

Interest revenue is recognized in surplus/deficit.

Impairment

Financial assets that are measured at amortized cost are subject to impairment.

Impairment losses shall be recognized in the surplus/deficit and used to reduce the carrying amount of the financial asset in the statement of financial position.

b. Fair value through net assets/equity

Interest revenue

Interest revenue shall be calculated by using the effective interest method similar to financial assets measured at amortized cost. Interest revenue shall be recognized in surplus/deficit.

Fair value gain/ losses

An entity shall determine the fair value of the financial asset at each reporting period.

The gain or loss on a financial asset measured shall be recognized in net assets/equity.

Dividend revenue

For equity instruments classified as measured at fair value through net assets, dividends are recognized in surplus /deficit.

Impairment

Financial assets that are measured at Fair value through net assets/equity are subject to impairment. The impairment loss allowance shall be recognized in net assets/equity and shall not reduce the carrying amount of the financial asset in the statement of financial position.

c. Fair value through Surplus/Deficit

Interest revenue

Interest revenue shall be calculated by using the effective interest method. Interest revenue shall be recognized in surplus/deficit.

Fair value gain/ losses

An entity shall determine the fair value of the financial asset at each reporting period. The gain or loss on a financial asset measured shall be recognized in surplus/deficit.

Fair value measurement considerations

- The best evidence of fair value is quoted prices in an active market.
- If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as input into a valuation technique to determine fair value.
- If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include:
 - Using recent arm's length market transactions between knowledgeable and willing parties
 - Reference to the current fair value of another instrument that is substantially the same,
 - Discounted cash flow analysis and option pricing models among others
- If available, an entity shall use a valuation technique commonly used by market participants to price the instrument if that technique has been demonstrated to

Equity Instruments Arising from Non-Exchange Transactions

In the public sector, equity investment can be used as a way for an entity to provide financing or subsidized funding to another public sector entity. The investment is meant to provide cash to the investee generally to further the investee's economic or social objectives.

Generally, the equity instrument is unquoted, and there are no or minimal future cash flow expectations from the investment besides a potential redemption by the issuing entity.

Examples: *investments in membership shares in a development bank, or equity investment in another public sector entity that provides certain social programs or services (e.g., shelters, subsidized housing, small business assistance)*

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If the intention at initial recognition is the provision or receipt of resources by way of a non-exchange transaction is accounted as follows.

- The receiving entity shall account for any assets or revenues arising from the transaction in accordance with IPSAS 23 i.e., revenue from non-exchange transactions.
- The entity providing the resources shall recognize the amount as an expense in surplus or deficit at initial recognition.

If the equity instrument does not arise from a non-exchange transaction, it shall be recognized initially at fair value. If the instrument does not have an active market, the entity shall consider the use of other valuation techniques and inputs in determining its fair value.

Subsequent measurement of financial liabilities

Subsequent measurement of financial liabilities is based on the classification of the financial liabilities.

Classification of Financial liabilities	Subsequent measurement
<ul style="list-style-type: none">• Amortized cost	Amortized cost
<ul style="list-style-type: none">• Fair value through surplus or deficit• Contingent consideration.	At fair value. The fair value changes accounted for in surplus/ deficit
<ul style="list-style-type: none">• Financial guarantee contracts• Commitments to provide a loan at a below-market interest rate	higher of: <ul style="list-style-type: none">i. The amount of the loss allowance determined andii. The amount initially recognized less, when appropriate, the cumulative amount of amortization.

Impairment

An entity shall recognize a loss allowance for expected credit losses on:

- a) A financial asset measured at amortized cost
- b) A financial asset measured at fair value through net assets/equity
- c) A lease receivable
- d) A loan commitment
- e) A financial guarantee contract.

Measurement of Expected Credit Losses

IPSAS 41 provides a single forward-looking model that eliminates the threshold for impairment recognition. The forward-looking model requires an entity to recognize expected credit losses at all times. This means it is no longer necessary for a trigger event to occur prior to recognizing a credit loss. IPSAS 41 is therefore an expected credit loss model.

An entity shall measure the expected credit losses of a financial instrument in a way that reflects:

- a) An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes.
- b) The time value of money
- c) Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

Expected credit losses are measured as either 12-month expected credit losses or lifetime expected credit losses.

Application of 12 months and Lifetime expected credit losses.

The application of 12 months expected credit losses or Lifetime expected credit losses is dependent on whether as at the reporting date, there has been a significant increase in credit risk or the asset is credit impaired.

12-month expected credit losses

12-month expected credit losses are a portion of the lifetime expected credit losses that represent expected credit that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months).

12-month expected credit loss is applicable for financial instruments that have not shown a significant increase in credit risk and are not credit impaired.

Lifetime expected credit losses.

For lifetime expected credit losses, an entity shall estimate the risk of a default occurring on the financial instrument during its expected life.

- Lifetime expected credit loss is applicable for financial instruments that have shown a significant increase in credit risk or are credit impaired.
- If an entity applies the simplified approach, the expected credit losses shall always be measured at an amount equal to lifetime expected credit losses.

Determining Significant Increases in Credit Risk

At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial asset.

- An entity default definition shall be consistent with the definition used for internal credit risk management purposes for the relevant financial instrument.
- There is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due.

An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date.

When determining whether a financial instrument has low credit risk an entity may apply either internal indicators (e.g., days past due) or external indicators (e.g., external credit ratings) or both.

There is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

Impairment Approaches

I. General Approach

Under the general approach an entity is required to track changes in credit risk and therefore the loss allowance measured under the general approach is based on either 12 months ECLs or lifetime ECLs.

Expected credit losses	Applicable to which financial instruments
12-month expected credit loss	Financial instruments that have not shown any significant increase in credit risk (low credit risk)
Lifetime expected credit loss	Financial instruments that have shown significant increase in credit risk. Credit-Impaired Financial Assets

II. Probability of Default' Approach

12-month expected credit loss is computed as follows:

$$ECL_{12m} = PD_{12m} \times LGD_{12m} \times EAD_{12m} \times D_{12m}$$

Lifetime expected credit loss is computed as follows:

$$ECL_{LT} = \sum_{t=1}^{LT} PD_t \times LGD_t \times EAD_t \times D_t$$

Where:

Probability of default (PD); likelihood that a borrower will not meet its contractual obligation as they fall due.

Loss Given Default (LGD); This is a measure of how much (in form of a percentage) a creditor is expected to lose in the event that a borrower defaults (default event occurs).

Exposure at default (EAD); The expected exposure in the event of default. It represents the amount owed by the borrower to the lender at time of the default.

Discount rate; Discount factor to discount cashflows in this case losses to the reporting date i.e., the effective interest rate.

III. Simplified Approach

Under the simplified approach an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses.

The simplified approach is applicable to

- a) Receivables that result from exchange transactions that are within the scope of IPSAS 9 and non-exchange transactions within the scope of IPSAS 23.
- b) Lease receivables that result from transactions that are within the scope of IPSAS 13. This is an accounting policy choice.

An entity may select its accounting policy for trade receivables and lease receivables independently of each other.

IV. Loss Rate Approach- Provision Matrix

An entity may use practical expedients when measuring expected credit losses. For example, an entity may calculate the expected credit losses on receivables using a provision matrix.

A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due. An example is as follows:

0 days past due	1- 30 days past due	30-90 days past due	>90 days past due
1%	3%	5%	20%

The provision matrix shall be based on an entity's historical credit loss experience. It shall also consider current conditions and forecasts of future economic conditions.

Portfolio segmentation

Depending on the diversity of its customer base, an entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. For examples, an entity can group assets using geographical region, product type, and type of customer among others.

NB: In relation to ECL, entities are advised to develop their own models based on their historical data and to incorporate peculiarities of their operations and the industry in which they operate. A model should be realistic and provide objectivity in the impairment process. Where an entity has investments in government securities and measured at amortized cost or fair value through net assets, impairment should be assessed at each reporting period by assessing both internal and external factors that indicate impairment. The standard requires that when measuring expected credit losses, an entity should consider the risk that a credit loss may occur even if the possibility of a credit loss occurring is very low. For financial instruments that have a low possibility of credit loss occurring shall have the credit loss measured over a 12- month period.

Hedge accounting

A hedge is an investment that is made with the intention of mitigating the risk of exposure to adverse price movements in an asset/liability that could affect profit or loss.

Common risks hedged against include interest rate risk, commodity price risk, foreign exchange risk, credit risk and equity price risk.

A hedge relation consists of a hedged item and a hedge instrument.

A hedged item exposes the entity to the risk of changes in fair value or future cash flows that could affect the current or future income statement.

A hedge instrument is a financial instrument whose fair value or related cash flows are used to offset changes in the fair value or cash flows of a hedged item.

Types of Hedge Relationships

- a) Fair value hedge: It is a hedge of the exposure to changes in the fair value of an asset or liability that is attributed to a particular risk and could affect profit or loss.
- b) Cashflow hedge: It is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognized asset or liability and could affect profit or loss.
- c) Hedge on net investment in a foreign operation: An entity may have overseas subsidiaries, associates, joint ventures or foreign branches. It may hedge the currency risk associated with the translation of the net assets of these foreign operations into the group's currency

Qualifying Criteria for Hedge Accounting

A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

- a. The hedging relationship consists only of eligible hedging instruments and eligible hedged items.
- b. At the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. The document shall describe:
 - The hedging relationship
 - Risk management strategy and objective for undertaking the hedge
 - The hedged item and hedging instrument
 - How hedge effectiveness will be assessed
- c. The hedging relationship meets all of the following hedge effectiveness requirements:
 - An economic relationship exists between the hedged item and the hedging instrument.
 - Credit risk does not dominate changes in value.

- The hedge ratio is the same for both the:
 - Hedging relationship
 - Quantity of the hedged item actually hedged, and the quantity of the hedging instrument used to hedge it.

4. Disclosures

Statement of Financial Performance

Interest revenue calculated using the effective interest method as well as gains and losses arising from the derecognition of financial assets measured at amortized cost.

Where a financial asset is reclassified out of the amortized cost measurement category so that it is measured at fair value through surplus or deficit, any gain or loss arising from a difference between the previous amortized cost of the financial asset and its fair value at the reclassification date.

Where a financial asset is reclassified out of the fair value through net asset/equity measurement category so that it is measured at fair value through surplus or deficit, any cumulative gain or loss previously recognized in net assets/equity that is reclassified to surplus or deficit.

Statement of changes in net assets/equity

Gains and losses on financial assets measured at fair value through net assets/equity.

Gains and losses from investments in equity instruments designated at fair value through net assets/equity.

For particular liabilities designated as at fair value through surplus or deficit, the amount of the change in fair value that is attributable to changes in the liability's credit risk.

Statement of Financial Position

Current assets which consist of items qualifying for the definition financial assets according to this standard.

Current liabilities which consist of items qualifying for the definition financial liabilities according to this standard.

Accounting Policies

Whether the contractual terms of a financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

5. Illustrative examples

Illustrative Example 1: Expected Credit Losses.

Question

Company A has taken a 10-year amortization loan – Kshs 1M.

Estimated probability of default – 0.5% over next 12 months

Loss on given default is estimated at 25%

At reporting date – no change in 12 months

No significant increase in credit risk since initial recognition

Lifetime ECL (Expected Credit Loss) not required. What is the ECL?

Solution

$ECL = EAD \times PD \times LGD$

$= 1,000,000 \times 0.5\% \times 25\%$

$= 1,250/=$

Question

An entity provides services to various recipients. The recipients are invoiced on a monthly basis based on the service consumed during the period. This represents a portfolio of trade receivables of Ksh. 30 million in 2023 for the entity. The portfolio consists of a large number of recipients with small balances outstanding. The trade receivables are categorized by common risk characteristics that are representative of the recipients' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component. The loss allowance for such trade receivables is always measured at an amount equal to lifetime time expected credit losses.

To determine the expected credit losses for the portfolio, the entity uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date, the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

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On that basis, the entity estimates the following provision matrix:

	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due
Default rate	0.3 percent	1.6 percent	3.6 percent	6.6 percent	10.6 percent

The trade receivables from the recipients amount to Ksh.30 million as follows.

Gross carrying amount (Kshs)	
Current	15,000,000
1–30 days past due	7,500,000
31–60 days past due	4,000,000
61–90 days past due	2,500,000
More than 90 days past due	1,000,000
30,000,000	

What is the Lifetime expected credit loss allowance.

Solution

	Gross carrying amount (Kshs)	Lifetime expected credit loss rate	Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)
Current	15,000,000	0.3%	45,000
1–30 days past due	7,500,000	1.6%	120,000
31–60 days past due	4,000,000	3.6%	144,000
61–90 days past due	2,500,000	6.6%	165,000

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More than 90 days past due	1,000,000	10.6%	106,000
	30,000,000		580,000

Question

Ushirika Motor Car Loan scheme fund originates a single 3-year amortizing car loan for KES 3 million to customer A at an annual fixed rate of 5%. There are no transaction costs or prepayment or call options.

Ushirika Motor Car Loan scheme fund estimates that the loan at initial recognition has a probability of default (PD) of 0.15% over the next 12 months. At the reporting date there has been no change in the 12-month PD and the exposure at default is determined to be KES 2,049,450

Ushirika Motor Car Loan scheme determines that there was no significant increase in credit risk since initial recognition. Ushirika Motor Car Loan holds Customer's A car logbook as collateral. After valuing this collateral (car) and discounting cashflows that would be received from sale of the car and time taken to realize it, Ushirika Motor car loan scheme determines that only 20 per cent of the gross carrying amount will be lost if the loan defaults (i.e., the LGD is 20% per cent).

Compute the loss allowance as at reporting date.

Solution:

Since the customer has not shown any significant increase in credit risk and it is neither is the loan credit impaired, Ushirika Motor Car Loan scheme shall measure the loss allowance at an amount equal to the 12-month expected credit losses.

$$ECL_{12m} = PD_{12m} \times LGD_{12m} \times EAD_{12m} \times D_{12m}$$

$$ECL = 0.15\% \times 20\% \times 2,049,450$$

$$\text{Undiscounted ECL} = 61,483.5$$

$$\text{Discounted at 5\%} = \text{KES } 61,483.5 \times (1+5\%)^{-1}$$

$$\text{12-month ECL} = \text{KES } 58,555$$

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Question

Tharaka Sewerage provides collection and disposal of sewage services for households within its geographical area. Households are invoiced on a monthly basis based on service provided. On 30th September 2022 Tharaka Sewerage had of trade receivables of KES 12 million all under one portfolio. The portfolio consists of a large number of households with small balances outstanding and are distributed as follows:

Days past due	Current	1–30	31–60	61–90	>90
Gross carrying Amount (KES)	3,500,000	2,700,000	2,000,000	1,900,000	1,900,000

The trade receivables do not have a significant financing component and therefore the loss allowance is measured using the simplified approach at an amount equal to lifetime time expected credit losses.

To determine the expected credit losses Tharaka Sewerage estimated the following provision matrix:

Days past due	Current	1–30	31–60	61–90	>90
Default rate	0.50%	2.50%	5%	10.5%	20%

The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates.

Compute the loss allowance as at reporting date.

Solution:

Tharaka Sewerage estimates the loss allowance using the provision matrix as follows:

Gross carrying Amount KES (a)	Loss rates (b)	Lifetime expected credit loss (a* b)
3,500,000	0.50%	17,500
2,700,000	2.50%	67,500
2,000,000	5.00%	100,000
1,900,000	10.50%	199,500
1,900,000	20.00%	380,000
12,000,000		764,500

Illustrative Example 2-Concessionary Loan (Interest Concession)

Question

A local authority receives loan funding to the value of KES 10 million from an international development agency to drill boreholes in arid and semi-arid areas. The agreement stipulates that the loan is to be repaid over the 5-year period as follows:

Period	Year 1	Year 2	Year 3	Year 4	Year 5
Principal repayment	5%	10%	20%	25%	40%

Interest is paid annually in arrears, at a rate of 5 percent per annum on the outstanding balance of the loan. A market-related rate of interest for a similar transaction is 10 %. There are no other conditions attached to the loan.

- 1) Using journal entries illustrate how the local authority will account for the concessionary loan at initial recognition.

Solution

The local authority has received an interest concession i.e., by paying a lower interest rate of 5% compared to the market-related rate of interest for a similar transaction is 10 percent.

The fair value of the loan is determined by discounting Contractual Cash Flows based on a Market Rate of 10%.

Amortization Schedule (Using Contractual Repayments at 5% Interest)

	Year 1	Year 2	Year 3	Year 4	Year 5
Principal repayment rate	5%	10%	20%	25%	40%
Principal	10,000,000	9,500,000	8,500,000	6,500,000	4,000,000
Interest (5%)	500,000	475,000	425,000	325,000	200,000
Payments (Interest) (a)	(500,000)	(475,000)	(425,000)	(325,000)	(200,000)
Payments (Principal) (b)	(500,000)	(1,000,000)	(2,000,000)	(2,500,000)	(4,000,000)
Balance	9,500,000	8,500,000	6,500,000	4,000,000	-

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Discounting Contractual Cash Flows (a+b) above (Based on a Market Rate of 10 %)

Year	1	2	3	4	5	Total
Total payments (Principal + Interest)	1,000,000	1,475,000	2,425,000	2,825,000	4,200,000	11,925,000
Present value of payments at 10%	909,091	1,219,008	1,821,938	1,929,513	2,607,870	8,487,420

Initial recognition journals

Dr: Bank/Cash- KES 10,000,000

Cr: Loan Liability- KES 8,487,420

Cr: Non-exchange revenue- KES 1, 512,580

- 2) Using journal entries illustrate how the local authority will account for interest accrual, interest payment and principal payment for the concessionary loan for Year 1.

Solution

Calculation of Loan Balance and Interest Using the Effective Interest Method

	Year 1	Year 2	Year 3	Year 4	Year 5
Principal repayment	5%	10%	20%	25%	40%
Principal	8,487,420	8,336,162	7,694,778	6,039,256	3,818,182
Interest Accrual (10%)	848,742	833,616	769,478	603,926	381,818
Payments (Interest 5%)	(500,000)	(475,000)	(425,000)	(325,000)	(200,000)
Payments (Principal)	(500,000)	(1,000,000)	(2,000,000)	(2,500,000)	(4,000,000)
Balance	8,336,162	7,694,778	6,039,256	3,818,182	(0)

Recognition of Interest Accrual using the effective interest rate.

Dr: Interest- KES 848,742 (10%* 8,487,420)

Cr: Loan Liability- KES 848,742

Recognition of interest paid on the outstanding balance.

Dr: Loan- KES 500,000 (10%* 500,000)

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Cr: Bank- KES 500,000

Recognition of Principal paid on the outstanding balance.

Dr: Loan- KES 500,000 (5%* 10,000,000)

Cr: Bank- KES 500,000

Illustrative Example 3-Equity Instruments Arising from Non-Exchange Transactions

Question

On January 1, 2022, National Power Ministry transfers KES 1,000,000 to Solar Energy Corporation. In exchange, Solar Energy Corporation issues 1000 common shares with a par value of KES 800 each. In transferring the KES 100,000, National Power Ministry granted a concession of KES 200,000, this is in bid to promote the use of renewable energy in households. The concession is evidenced in the transaction documentation.

At the same period, Solar energy corporation issues shares to other parties at a par value of KES 800.

How does National Power Ministry account for the transaction?

Solution

At initial recognition, National Power Ministry determines the fair value of the shares to be equal to the transaction price i.e., KES 800,000 (800*1000). This is also evidenced by other similar transactions that Solar Energy Corporation has had with other parties.

Dr: Investment in Equity shares- KES 800,000

Dr: Expense (Accounting for or concession)- KES 200,000

Cr: Cash- KES 1 000,000

Illustrative Example 4- Reclassification of Financial Assets

Question

An entity purchases a portfolio of bonds for its fair value (gross carrying amount) of KES 400,000 and classify the bonds as subsequently measured at amortised cost.

The entity changes the management model for managing the bonds from collecting contractual cashflows to trading. At the date of reclassification, the carrying amount of the bond was KES 380,000 (i.e., 400,000- accumulated impairment losses (20,000)). The fair value of the portfolio of bonds at the reclassification date is KES 370,000.

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Account for the acquisition of the bonds, ECL recognition on Amortised cost method and reclassification to FVTSD.

Solution

Initial Recognition Journals:

Dr: Financial asset – Amortised cost -KES 400,000

Cr: Cash – KES 400,000

Subsequent ECL Journals

Dr: Impairment loss (Surplus/Deficit) -KES 20,000

Cr: Financial asset Accumulated impairment a/c– Amortised cost -KES 20,000

Reclassification Journals

Dr: Financial asset – FVTSD -KES 390,000

Dr: Financial asset Accumulated impairment a/c– Amortised cost -KES 20,000

Cr: Financial asset (Gross carrying amount)– Amortised cost -KES 400,000

Cr: Reclassification gain KES 10, 000 (KES 390,000- KES 380,000)

Illustrative Example 5-Debt Instrument Measured at Fair Value Through Net Assets/Equity

Question

On 1st January 2021 Utumishi Fund bought 1000 bonds from Unity Bank at KES 100 per bond at 10% interest rate. Utumishi Fund carries the bonds at fair value through net assets/Equity. During the year, Utumishi Fund received CU 1000 as interest from the bonds. At initial recognition the Utumishi Fund determines that the asset is not purchased or originated credit impaired.

On 31st December 2021 the market price of the bond was KES 95. The fair value of the bond had decreased as a result of changes in market interest rates and exposure of Unity bank to adverse business and economic conditions leading to a downgrade of Unity bank credit rating from AA+ to BBB- by Standards & poor's (S&P). The EIR is assumed to be 10%.

Utumishi Fund concludes that Unity bank credit risk has significantly increased and estimates the lifetime expected loss of KES 3000.

Required:

- i. Determine the initial recognition journal entries on acquisition of the bonds
- ii. Determine the value of the bonds as at 31 December 2021 and the Journal entries to be passed for impairment and fair value change.

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Solution

i. Initial Recognition Journals:

Dr: Financial asset – FV in Net assets/Equity -KES 100,000 (1000*100)

Cr: Cash – KES 100,000

ii. Value of the bonds as of 31 December 2021- KES 95,000 (1000*95)

Dr: Impairment in P& I – KES 3,000

Dr: FV Loss in Net assets/Equity – KES 2000 (KES 5000- 3,000)

Cr: Financial asset – KES 5,000 (100,000- 95,000)

The cumulative loss in net assets/equity at the reporting date was KES 2000. That amount consists of the total fair value change of KES 5,000 (i.e., KES100,000 – KES 95,000) offset by the change in the accumulated impairment amount representing lifetime expected credit losses that was recognized (KES 3,000).

6. Emerging issues in application.

Financial Assets

At the date of initial application, an entity shall assess whether a financial asset is held within a management model whose objective is to hold financial assets in order to collect contractual cash flows or is held within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets on the basis of the facts and circumstances that exist at that date. The resulting classification shall be applied retrospectively irrespective of the entity's management model in prior reporting periods.

At the date of initial application an entity may designate:

- (a) A financial asset as measured at fair value through surplus or deficit so as to eliminate or significantly reduce a measurement or recognition inconsistency if recognised through other bases.
- (b) An investment in an equity instrument as at fair value through net assets/equity where an entity elects to.

Such a designation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

Financial Liabilities.

At the date of initial application, an entity:

- (a) May designate a financial liability as measured at fair value through surplus or deficit so as to eliminate or significantly reduce a measurement or recognition inconsistency if recognised through other bases.
- (b) Shall revoke its previous designation of a financial liability as measured at fair value through surplus or deficit if such designation was made at initial recognition so as to eliminate or significantly reduce a measurement or recognition inconsistency if recognised through other bases and that such designation does not satisfy that condition at the date of initial application.
- (c) May revoke its previous designation of a financial liability as measured at fair value through surplus or deficit if such designation was made at initial recognition so as to eliminate or significantly reduce a measurement or recognition inconsistency if recognised through other bases and that such designation satisfies that condition at the date of initial application.

Such a designation and revocation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

NOTE: Statutory payments do not form part of financial instruments.

Disclaimer:

This guideline has been prepared as a guidance to public sector entities in Kenya for implementation of IPSAS 41. However, it does not serve as an advisory or complete standard documentation of Financial Instruments or a replacement of IPSAS 41. For further engagements on IPSAS 41 reach out to us on acctstandards@psasb.go.ke