THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE

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ACCOUNTING FOR TREASURY BILLS

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE

Mission

"To enhance the International standing and recognition of the qualification Chartered Accountant (Zimbabwe), for the benefit of its members, to support them in providing quality services in the public interest.

Vision

"To be the pre-eminent professional body in the development and promotion of accountancy, assurance and advisory services, business and good governance practices."

Values

Honesty
Upholding the truth – no half truths, putting across the right facts, being impartial and full disclosure.

Responsibility
Taking ownership and being dependable.

Integrity
Acting in good faith, standing by what we believe in, independent, fair and transparent, do the right thing, walk the talk in respect of all things.

Focus Goal

Expand the ICAZ membership while maintaining quality and growing influence.

Accounting for Treasury Bills

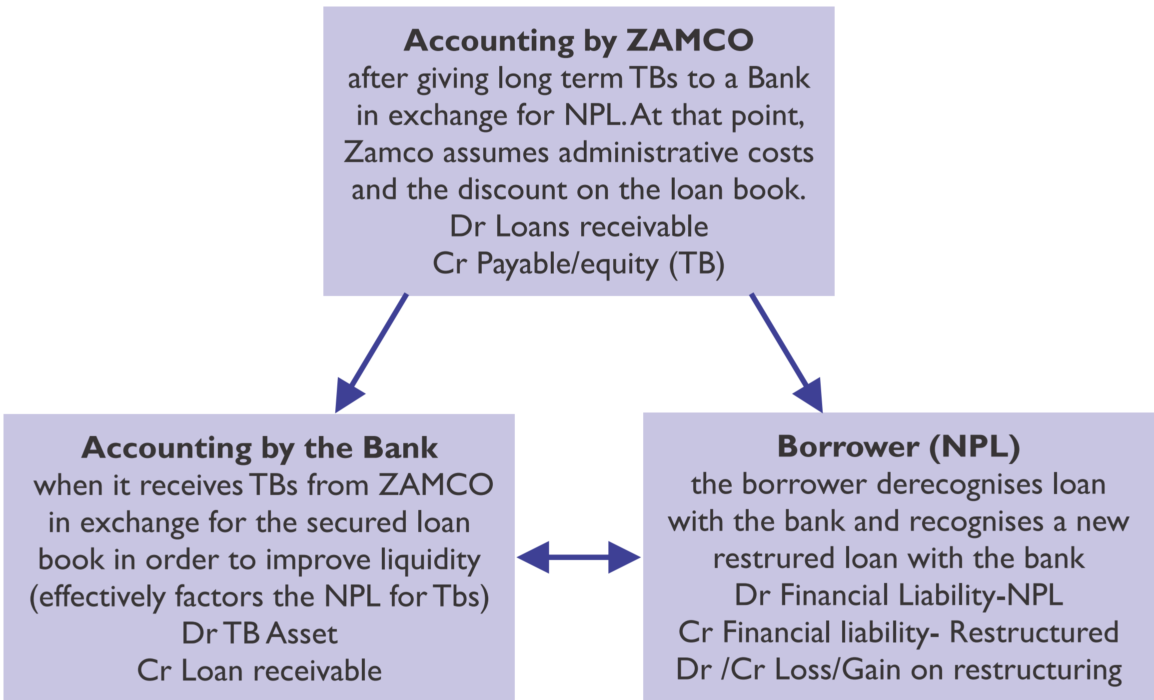
1. Introduction

ICAZ aims to provide value to its members as well as lead the market in areas of its competence through regular technical bulletins. Thus, the objective of this paper is to provide guidance on the accounting treatment for treasury bills that are now a common feature in the Zimbabwe financial market. The accounting treatment is based on the input from various market stakeholders (audit practitioners, preparers of financial statements of respective entities etc.), and perusal of the underlying instrument contracts. This Technical Bulletin only discusses the Zimbabwe Asset Management Company (ZAMCO) Treasury bills (TBs).

2. Background to ZAMCO TBs

The purpose of the ZAMCO TBs is to clean up the balance sheet of banks and improve liquidity at the same time assist distressed borrowing companies with a new lease of life. Only secured loans from salvageable companies are bought by ZAMCO. ZAMCO takes over the loan books in exchange for the TBs which they then issue out at a lower consideration.

Fig. 1: Loan arrangement between borrower and lender and ZAMCO



The non-performing loans taken over by ZAMCO are assessed on an individual basis, thus case by case which then influences the discount at which the NPL is bought at.

3. Accounting Issues

The IFRS implications for the bank, ZAMCO and the borrower would be examined under this section. Note that IAS 39 shall be used to determine the basis of accounting, since this is the current effective standard. Comments on IFRS 9 are also made to indicate differences or similarities with IAS 39.

The accounting treatment for all involved parties in the ZAMCO TB is discussed for completeness purposes.

3.1 Bank

Should the bank derecognize the NPL and recognize the TB asset or rather it should continue with the NPL balances?

The bank is transferring its rights and obligations on the NPL to ZAMCO and therefore the bank has to strongly consider whether the transfer qualifies for derecognition or no derecognition.

Derecognition normally happens where there is a substantial modification. Derecognition principle in IAS39 (paragraphs 16-20) is the same with the one in IFRS9.3.2. IAS 39 paragraph would be used as most entities have not adopted IFRS9 at the time of writing.

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

(a) the contractual rights to the cash flows from the financial asset expire; or

(b) <u>it transfers the financial asset as set out in paragraphs 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20. [IAS39.17]</u>

An entity transfers a financial asset if, and only if, it either:

(a) <u>transfers the contractual rights to receive the cash flows of the financial asset; or</u>

(b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19. [IAS39.17]

The bank transfers the financial asset by transferring the contractual right to receive cash from the borrower as per paragraph 17(a) and 18(a). The key question left is whether this transfer qualifies for derecognition as per paragraph 20.

When an entity transfers a financial asset (see paragraph 18), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

(a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

(b) if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset. [para 20]

One of the ZAMCO agreements reviewed read as follows: "X bank hereby agrees to sell without recourse and transfer to ZAMCO and ZAMCO agrees to purchase and accept from X bank all the rights, title and interest of X bank in and to the NPL including any other documents or interest delivered to it with respect to the NPL".

Further examination of the agreement showed that X bank was just supposed to hand over the NPL loan agreement and documents as are and there was no indication that ZAMCO had recourse from the bank in case of non-performance by the borrower post signing of the agreement. The bank had even to notify the borrower of the arrangement with ZAMCO.

Thus, the bank has transferred the significant risks and rewards of ownership. This is also evidenced by the fact that the TB principal balance or consideration is lower than the NPL outstanding loan amount. The bank should therefore derecognise the old asset and recognise the new financial asset arising from the TBs received from ZAMCO.

According to paragraph 25 of IAS 39, if, as a result of a transfer, a financial asset is derecognised in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity shall recognise the new financial asset, financial liability or servicing liability at fair value.

Paragraph 26 refers: On derecognition of a financial asset in its entirety, the difference between:

(a) the carrying amount and

(b) the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income (see paragraph 55(b)) shall be recognised in profit or loss.

Dr ZAMCO TB financial Asset (SFP)	xx
Dr Allowance for credit losses (SFP)	xx
Dr Loss on transfer of NPL (P/L)	xx
Cr Loan receivable from borrower-NPL (SFP)	xx

Being derecognition and recognition of a new financial asset

NB: As identified above the loss is recognised immediately in the profit or loss account and should not be confused to be either impairment loss or increase in credit loss allowance. The loss arises from restructuring the loan or a de facto factoring exercise at a price which less than the carrying amount of the asset held. It is not a result of the assessment of possible irrecoverable amounts.

The loss/gain on transfer need to be presented and disclosed separately in the financial statements and relevant facts and circumstances should be adequately disclosed. It is an actual loss as it is a result of an actual agreement (ZAMCO TBs) which has a price lower than the carrying amount of the financial asset transferred.

Measurement: The ZAMCO TB asset shall be measured at fair value (present value of the face value and the coupons based on a market return or rather transaction price at that date), [IAS39.43.] This is in line with IFRS 9.5.1.1. Subsequently, the TB asset can be held at as either loan and receivable or held to maturity whichever is appropriate for the bank and be measured at amortised cost at the end of the year.

3.2 Borrower

Is the restructuring of the loan a non-substantial modification or a substantial modification which could result with derecognition of financial liability and recognition of a new liability with ZAMCO in terms of IAS 39 Par 40-41?

The reason for considering modification in the books of the borrower arises from the fact that the borrower has the same obligation before and after the transaction between the bank and ZAMCO. The assessment of the impact of the modification aims to assess whether ZAMCO assumed the loan and the effect of restructuring would be non-substantial (less than 10%) or substantial in such a way that the old liability be derecognised and a new one is recognised.

Paragraph 40-41: An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

IAS39.AG62 described substantial modification as follows:
For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

3.3 Worked example

The borrower has a $1 million loan facility that it was servicing over the remaining 3 years at 10% from the bank. The loan's effective interest rate is 12% and the face value would be repaid at the maturity date. The bank transferred the loan to ZAMCO at the beginning of the year with 3 remaining service years. ZAMCO restructured the loan so that it may be paid over 6 years at 8% coupon and only 90% of the face value would be repaid at end of year 6. US$5000 costs were incurred for restructuring the loan in form of legal fees, etc.

Carrying amount = Present Value (PV): n=3, i=12%, pmt=$100,000, FV=$1 million, PV= 951 963.37

New Carrying amount = Present Value (PV): n=6, i=12%, pmt=$80,000, FV=$900 0000, PV=784 880.59

Difference = 167 082.78 (951 963.37 less 784 880.59), thus, 167 082.78/951 963.37=17.55% (greater than the 10% referred to above)

If this is the case, then the modification is substantial, which result in the extinguishment of the original contract and replacement with a new one. The borrower should therefore derecognise the old liability (extinguished liability) and replace with a new liability and recognise the resulting gain or loss in profit and loss. The new liability will be initially measured at fair value using the prices at the date of modification. The $5000 would also be recognised directly in profit or loss.

If the difference is less than 10% then the original liability has NOT been extinguished and shall be retained and as such both the gain or loss and the related costs are amortised over the remaining term of the loan.

3.4 Restructured loan at ZAMCO

How should ZAMCO account for the restructured loan with the borrower and its obligation to the bank with regards to the TB?

ZAMCO has an obligation to deliver cash in form of interest and principal (a financial liability) to honour the TB issued as consideration to the bank. It also has a right to receive interest and principal on the restructured loan arrangement (financial asset) with the borrower.

The loan from the borrower can be classified as a loan receivable in terms of IAS 39 or amortised cost in terms of IFRS9 and initially be measured at fair value and subsequently measured at amortised cost.

The financial liability can also be classified at amortised cost and initially be measured at fair value and subsequently measured at amortised cost.The loan asset from the borrower and the TB issued to the bank are not necessarily the same instruments and have no risk of causing accounting mismatch, thus, they do not need to be classified as fair value through profit and loss. [IAS 39.47]

Dr Financial Asset (SFP) - Loan receivable
Cr Financial liability (SFP) - TB Obligation
Dr/Cr Loss/Gain on acquisition of NPL
Initial recognition of loan asset and TB liability at acquisition.

Dr Bank (SFP)
Cr Interest Income (P/L)
Cr Financial Asset (SFP)-Loan
Amortisation of interest income on loan receivable.

Dr Interest expense (P/L)
Dr Financial liability (SFP)-TB
Cr Bank (SFP)
Amortisation of interest expense on TB.

Key:
SFP - Statement of financial position
SCE - Statement of Changes in Equity
P/L - Profit & Loss
OCI - Other Comprehensive Income
RBZ - Reserve Bank of Zimbabwe
TB - Treasury bill

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