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ETHIOPIA'S IFRS IMPLEMENTATION-THE JOURNEY TO-DATE AND THE WAY FORWARD

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OCTOBER 13, 2022

Survey Report

CFO Forum Ethiopia 2022

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More than 70% of countries in the world adopted International Financial Reporting Standards (IFRS), a global financial reporting framework promulgated by International Accounting Standards Board (IASB). The need for initial issuance and later global acceptance of these standards revolved around the 2008 Asia Financial Crisis, Globalization of Free Movement of Capital Across Markets, formation of the European Union and the 2008 Global Financial Crisis. Key benefit of the global reporting framework, among others, is believed to be harmonization of the scattered national standards enhancing easier understanding and comparability of financial statements.

The House of people's Representative of the Federal Democratic Republic Ethiopia enacted Financial Reporting Proclamation No. 847/2014 and this was followed by Council of Ministers Regulation No. 322/2014 which established the Accounting & Auditing Board of Ethiopia (AABE). Accordingly, AABE has prepared a roadmap by which significant public interest companies (PIEs) are expected to adopt IFRS and be compliant with full IFRS by June 30, 2019, and subsequently extended the date to June 30, 2022. Similar roadmap with later extension was also set for other PIEs and Small and Medium-sized Entities (SMEs), with criteria for classification in the three categories.

The objective of the roadmap is to set out strategies for a smooth transition from the Current Accounting Practice to International financial reporting standard (IFRS).

To this end, almost all significant PIEs, most of other PIEs and few of SMEs have completed the transition. Yet the issues of IFRS implementation do not end on transition as the implementation will continue from year to year.

In this article, I'll emphasize on issues I consider important during initial conversion to and subsequent implementation of IFRS. With objective of making the issues and the resulting point of arguments more practical, though I, as an auditor for more than 25 years, have vast and diversified experience in Ethiopia's accounting practice, before and after implementation of IFRS and can be given some leeway to confidently comment on the issues, survey has been conducted to obtain inputs of not few reporting entities and their external auditors and result of the survey is also incorporated hereunder.

1 Difficult/Impractical Standards

Options available to nations in deciding financial reporting framework to use are:

i. Use locally developed reporting standards;
ii. Fully adopt the global standards (IFRS); or
iii. IFRS convergence (use local standards compliant/in-line with IFRS) instead of full adoption.

Each option has its own pros and cons and it is beyond this article to go to that detail. Ethiopia has gone for option ii and when IFRS is adopted, it should be done fully and wholly (all IFRSs, IASs, application guidance, interpretations, etc); no half-way implementation.

Yet, considering the context of specific countries adopting IFRS, all standards may not be equally applicable, and some standards might not be suitable/practical to implement. Which standards fall in these categories from Ethiopian context and what actions should be taken by AABE, the regulator, and the reporting entities? That are questions I try to address in this section.

From my viewpoint, standards falling in these categories mainly are:

i. IFRS 13- Fair Value Measurement and other standards using fair value concept (including IAS 41 Agriculture)- because basically of difficulty in obtaining and/or measuring fair value through all allowed approaches (market, income or replacement cost); and
ii. IFRS 9 Financial Instruments- Measurement and 7 Financial Instruments- Disclosure- because, mainly, of difficulty in measurement (whether at fair value or amortized cost) and extensive disclosure requirement which. considering the nature and areas of emphasis of users of financial statements in Ethiopia, might be argued as costing too much time of the preparers and auditors.

IFRS 13- Fair Value Measurement

The following standards were noted as requiring, in one way or another, measurements at fair value:

a) **IAS 16 - Property, Plant and Equipment and IAS 38- Intangible Assets**
  - Items that are measured using the revaluation model (i.e., fair value at the date of revaluation less subsequent accumulated depreciation and impairment).

a) **IFRS 15 – Revenue from Contracts with customer**
  - Revenue is required to be measured at the fair value of the consideration received. This is particularly relevant during exchange of dissimilar goods or services (when consideration is paid in kind).

b) **IFRS 3- Business Combination**
  - Identifiable assets and liabilities of an acquiree are measured at fair value
  - Non-controlling interest can be measured at fair value at the date of

acquisition; and
  - Previously-held equity interest is measured at fair value on a step acquisition.

c) **IFRS 5- Non-current assets and/or disposal groups held for sale**
  - Non-current assets and/or disposal groups are measured at the lower of carrying amounts and fair value less costs to sell.

d) **IAS 36- Impairment**
  - When the recoverable amount is determined based on "fair value less costs of disposal".

e) **IFRS 9 and 7 and IAS 32- Financial Instruments**
  - Financial assets and liabilities are measured at fair value on initial recognition
  - Financial assets and liabilities that are measured at fair value at the subsequent reporting dates;
  - Financial assets and liabilities that are not measured at fair value at subsequent reporting dates but disclosure of fair value is required in accordance with IFRS 7; and
  - Fair value of a compound instrument as a whole.

f) **IAS 40- Investment Property**
  - Investment properties that are measured using the fair value model; and
  - Investment properties that are measured using the cost model – still need to apply IFRS 13 because IAS 40 requires disclosure of fair value.

g) **IAS 41- Agriculture**
  - Biological assets are measured at fair value on initial recognition and at each reporting date; and
  - Agricultural produce are measured at fair value at the point of harvest.

h) **Interpretations**
  - IFRIC 13- Customer Loyalty Programmes;
  - IFRIC 17- Distributions of Non-cash Assets to Owners;
  - IFRIC 18- Transfers of Assets from Customers; and
  - IFRIC 19- Extinguishing Financial Liabilities with Equity Instruments;

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures and applies to both initial and subsequent measurement as to how to determine fair value. It does not address which types of assets, liabilities and items classified as an entity's own shareholders' equity should be measured at fair value.

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

In determining fair value, the standard requires the following to be considered:

i. **Unit of account**- What is being measured? What is the appropriate unit of account? Is it the same as the basis for valuation?
ii. **Market**- What is the principal (or if none exists, the most advantageous) market?
iii. **Assumptions**- What assumptions would market participants in the principal (or the most advantageous) market consider when pricing the

asset or liability? What characteristics of the asset or liability would market participants take into account?

iv. **Inputs and valuation techniques**- What inputs are available and could be used in determining the fair value? What is (are) the appropriate valuation technique(s)?

In relation to this, the following has been defined as follows:

- **Observable inputs**- Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.
- **Unobservable inputs**- Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.
- **Active market**- a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
- **Principal market**- the market with the greatest volume or level activity for the asset or liability.
- **Most advantageous market**- the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after considering transaction costs and transport costs.

IFRS 13 recognizes three alternative valuation techniques:

- **Market approach**- Prices and other relevant information generated by market transactions involving identical or comparable items
- **Cost approach**- Current replacement cost (the cost to a market participant buyer to acquire/construct a substitute asset)
- **Income approach**- Convert the future amounts (cash flows or values, reflecting current market expectation) into a single current amount

From Ethiopian context, of all the above, the following are areas of challenge:

a) **Market**- identifying the principal or most advantageous market.
b) **Inputs**- obtaining observable inputs.
c) As a result of the two factors above, difficulty in applying either of the alternative valuation techniques.

IFRS 9 Financial Instruments- Recognition and Measurement and IFRS 7 Financial Instruments- Disclosure

A. Definition

- Financial instrument- any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
- Primary instrument- a financial investment whose price is based directly on its market value. It can be any type of financial investment that is priced based on its own value. Example- Cash, receivables, investments, payables, etc.

- Secondary (derivative) instrument- Derivatives create an alternative product for investors seeking to benefit from changes in the market value of primary instruments. They are known as non-primary instruments. Call and put options, and futures are some of the derivatives that can be used to profit from primary instruments. Derivatives get their name because they are derived from the primary (underlying) asset.

B) Initial measurement- Fair Value-purchase consideration paid to acquire the financial assets.

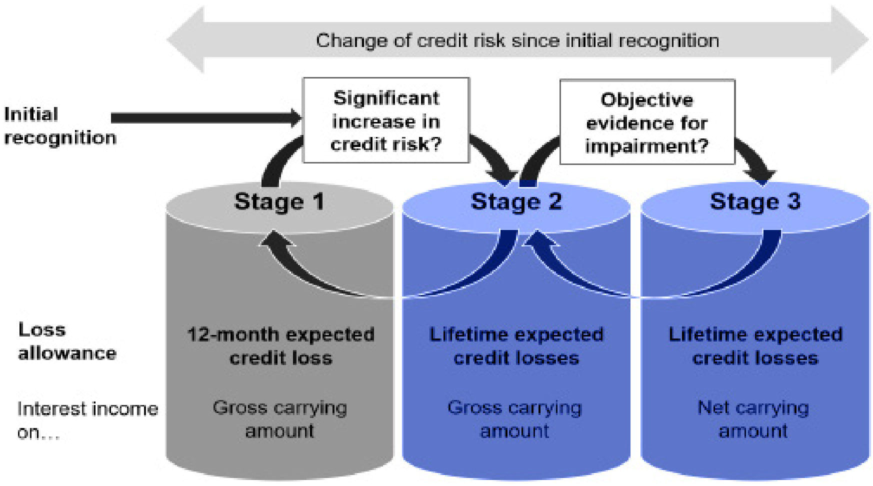
C) Subsequent measurement

- Financial assets measured at fair value through profit or loss (FVTPL);
- Financial assets measured at fair value through other comprehensive income (FVTOCI)
  - o with gains and losses remaining in other comprehensive income (OCI) without subsequent reclassification to profit or loss.
  - o with cumulative gains and losses reclassified to profit or loss upon derecognition.
- Financial assets measured at amortised cost

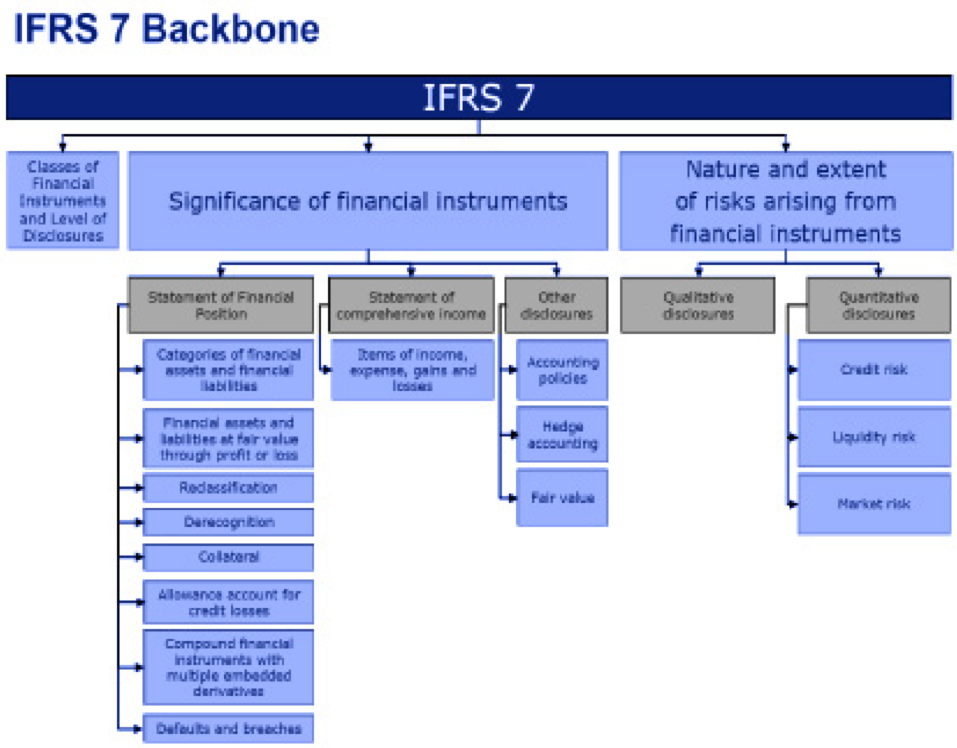
D) Business models

- Held to collect- the entity's objective is to hold the asset (or portfolio of assets) to collect the contractual cash flows;
- Held to collect and sell- an entity holds financial assets in order to achieve a particular objective by both collecting contractual cash flows and selling financial assets; and
- Held for trading- a financial asset or group of financial assets is not held within the hold to collect or the hold to collect and sell business model (e.g. exclusively for sale).

E) Impairment- expected credit loss (ECL) model



F) IFRS 7- Disclosure



i. Classes of financial instruments

- Some disclosures by category and others by class; and
- Take into account characteristics of financial instruments.

ii. Statement of Financial Position

❖ **Categories of financial assets and liabilities**- A requirement to disclose the carrying amount of each of the following categories either in the statement of financial position or in the notes:

➢ Financial assets at fair value through profit or loss (FVTPL), showing separately financial instruments that the entity:
  - Designated as FVTPL upon initial recognition; and
  - Classified as held for trading.
- Held-to-maturity investments;
- Loans and receivables;
- Available-for-sale financial assets;
- Financial liabilities at FVTPL, showing separately financial instruments that the entity:
  - Designated as FVTPL upon initial recognition; and
  - Classified as held for trading.
- Financial liabilities measured at amortized cost;
- Derivates that are hedging instruments.

❖ **Financial assets or financial liabilities designated at fair value through profit or loss (FVTPL)**

➢ Measurement of credit risk with method used;

➢ If entity believes the measure of credit risk is not representative, state why and give relevant factors.

Financial assets

- Maximum exposure to credit risk;
- The amount by which maximum exposure is modified by a mitigating derivative;
- The amount of change in the fair value due to credit risk (period and cumulative); and
- The amount of change in the fair value of mitigating derivative (period and cumulative).

Financial liabilities

- The amount of change in the fair value of liability due to credit risk (period and cumulative); and
- The difference between the financial liability's fair value and the maximum contractual amount the entity has to pay.

❖ **Methods of measuring credit risk**
- Method 1- The amount of change in the fair value of financial instrument that is not attributable to changes in market conditions that give rise to market risk. Changes in market conditions that give rise to market risk include:
  - Benchmark interest rates
  - Foreign exchange rates
  - Commodity prices, prices of similar instruments, indices of prices or rates, etc.
- Method 2- An alternative method the entity believes more faithfully represents the change in fair value of financial instrument due to credit risk.

❖ **Reclassification and Derecognition**
- Reclassification- the amount reclassified into and out of categories (cost or amortized cost to fair value and vice versa) and the reason; and
- Derecognition- when transferred assets do not qualify for derecognition in whole or in part, disclose the nature and the carrying amount of the assets and of the associated liabilities and the nature of risks and rewards of ownership.

❖ **Allowance accounts, collateral, and compound instruments**
- Allowance accounts- reconciliation of changes in the allowance (by class of financial asset) during the period;
- Collateral
  - Carrying amount of the financial assets pledged and terms and conditions relating to its pledge; and
  - If entity holds collateral, the fair value of that collateral and the terms and conditions associated with its use of collateral.
- Compound instruments issued with multiple embedded derivatives.

❖ **Defaults and breaches**
➢ For loans payable, disclose:
  - Any defaults of principal, interest, sinking fund, or redemption terms of those loans payable;

    - The carrying amount of the loans payable in default at period-end; and
    - Whether defaults are remedied, or loans renegotiated before financial statements are authorized for issue.
  - If other breaches of agreement terms, disclose the same information as above if lender was permitted to demand accelerated repayment.

iii. Statement of comprehensive income

- Net gains or losses for each category;
- Total interest income and expense for instruments not at FVTPL;
- Fee income and expense separate from financial instruments not at FVTPL and from trusts and other fiduciary activities that result in the holding or investing of assets on behalf of third parties;
- Interest income on impaired financial assets accrued; and
- The amount of any impairment loss per class.

iv. Other disclosures

❖ **Accounting policies and hedge accounting**

- Significant accounting policies:
  - The measurement basis and other accounting policies used.
- For all hedges, description of:
  - The type of hedge;
  - Instruments designated as hedging instruments, and their fair values; and
  - The nature of the risks being hedged.
- Additional disclosures about cash flow hedges;
- Ineffectiveness of cash flow and net investment hedges recognized in profit or loss; and
- For fair value hedges:
  - Gains or losses on hedging instrument; and
  - Gains or losses on hedged item attributable to the hedged risk.

❖ **Other disclosures–Fair value**

Amendments to IFRS 7 introduce 3-level hierarchy (similar to US GAAP).

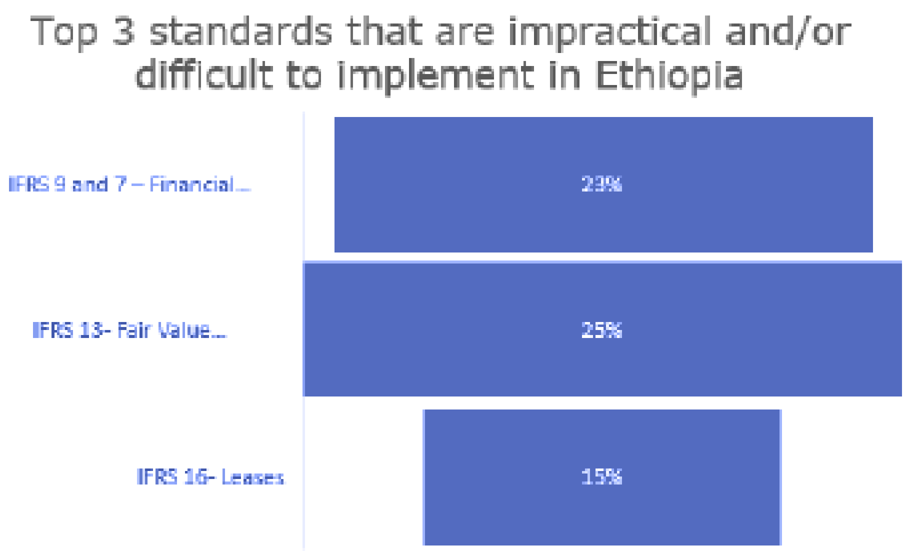
- Level 1: quoted prices in active markets for the identical instruments (i.e., unadjusted);
- Level 2: inputs other than quoted prices in Level 1 that are observable either directly or indirectly; and
- Level 3: inputs that are not based on observable market data;
- Disclosure by class;
- Methods and assumptions in determining fair value;
- If change in valuation technique, disclose the change and the reason;
- For Level 1 and 2, disclose transfers between levels and reasons behind them;
- For Level 3, disclose by class:
  - Reconciliation from beginning to the ending balances, including:
    - Total gains and losses recognized in profit or loss (P+L) and where they are presented;
    - Total gains and losses recognized in other comprehensive income;
    - Purchases, sales, issues, and settlements (each separately); and
    - Transfers into and out of Level 3 and reasons;

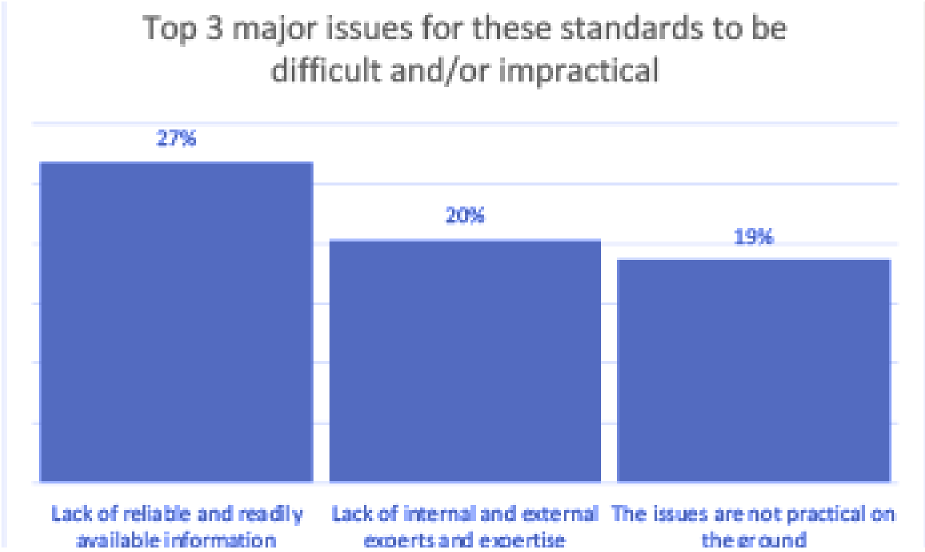
- The amount of P+L gains losses for instruments still held at period-end; and
- Effect of changes in reasonably possible alternative assumptions.

v. Nature and extent of risks arising from financial instruments

- Qualitative Disclosures:
  - Types of risk exposures and how they arise;
  - Risk management objectives, policies, and processes, as well as risk measurement methods; and
  - Any changes in the above items from the previous period.
- Quantitative Disclosures:
  - Summary of Quantitative Data— for each type of risk, information about the risk exposure as of the reporting date, based on information provided to key management personnel;
  - Concentrations of risk;
  - Credit Risk—information should include maximum exposure, aging (with particular focus on amounts that are past due), impairments, and a description of collateral by class of financial instrument;
  - Liquidity Risk—information should include a maturity analysis for non-derivative and derivative financial liabilities and a description of how the company manages the liquidity risk;
  - Market Risk—information should include a sensitivity analysis for each type of market risk, showing how profit or loss and OCI would be affected by certain changes in the risk variable. Disclose also:
    - Methods and assumptions used in that sensitivity analysis; and
    - Any changes in methods and assumptions from the prior period.
  - The quantitative disclosures would be based on information provided to key management personnel.

Survey results:





What can reporting entities do?

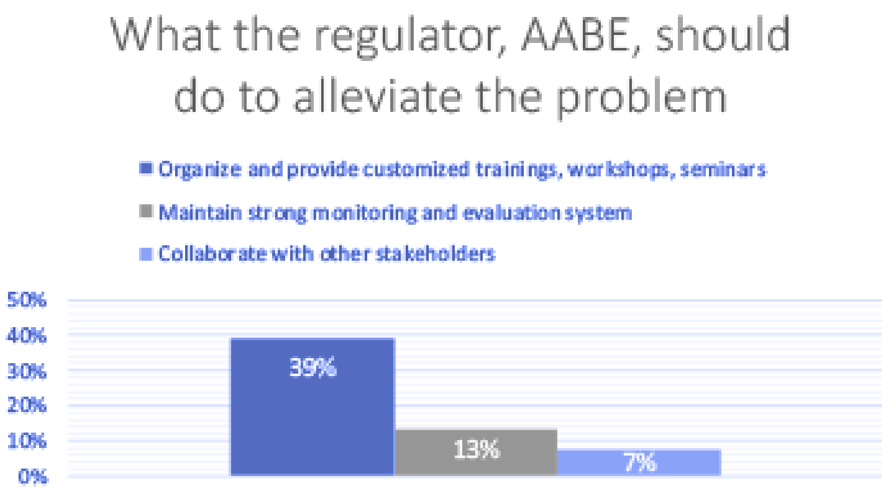
As shown above, fair value measurement is challenging because of problems in market identification and obtaining primary inputs and the disclosure requirement of IFRS 7 is so extensive that I sometimes wonder whether the reporting entities have the time, information and expertise it requires and whether it worth the effort given the type and number of financial statement users who ought to read the report with required degree of attention, understand the message and use it to make informed decisions.

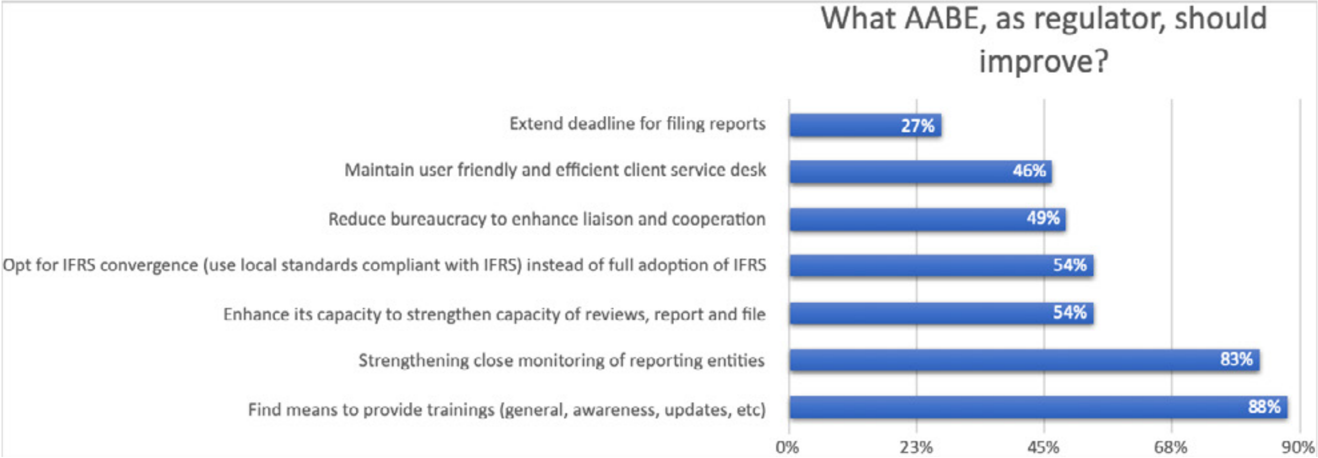
The challenges to the reporting entities are there. As there is no option of half-way implementation of IFRS, they need to strengthen their internal technical capacity and seek external advisory services as and when needed.

What should AABE, the regulator, do?

We all know that it is only few years since AABE is stablished, yet its duties and responsibilities are vast. It needs detailed research and survey to comment on what AABE should exactly do and/or improve in this regard. Hence, I refrained from commenting on the issue.

Survey results show:





2 Standards requiring attention/emphasis

What we have seen so far are standards that are difficult and/or impractical to implement from Ethiopian context. Yet, there are many standards relatively practical and not difficult to apply, but were not given the attention/emphasis they deserve including, among others:

i. IFRS 5- Non-current Assets Held for Sale and Discontinued Operations;
ii. IFRS 8- Operating segments;
iii. IAS 8- Accounting Policies, Changes in Accounting Estimates and Errors;
iv. IAS 10- Events after the Reporting Period;
v. IAS 21- the Effects of Changes in Foreign Exchange Rates;
vi. IAS 23- Borrowing Costs;
vii. IAS 28- Investments in Associates and Joint Ventures;
viii. IAS 36- Impairment of Assets;
ix. IAS 36- Provisions, Contingent Liabilities and Contingent Assets;
x. IAS 16- Property, Plant and Equipment, hereinafter referred to as PPE.

I'll discuss in more detail the case of IAS 16 as, from my viewpoint, as it is more practical on one hand and many of its provisions are disregarded or misapplied on the other.

The standard covers, among others:

i. Recognition criteria and measurement at recognition;
ii. Subsequent costs;
iii. Subsequent measurement;
iv. Depreciation;
v. Impairment;
vi. Derecognition; and
vii. Disclosure.

Where lies the misapplication or absence of required degree of emphasis/attention?

i. Initial measurements

As per IAS 16 paragraph 15, 'an item of PPE that qualifies for recognition as an asset shall be measured at cost'.
Cost, here, is amount of:

- cash or cash equivalents paid; or

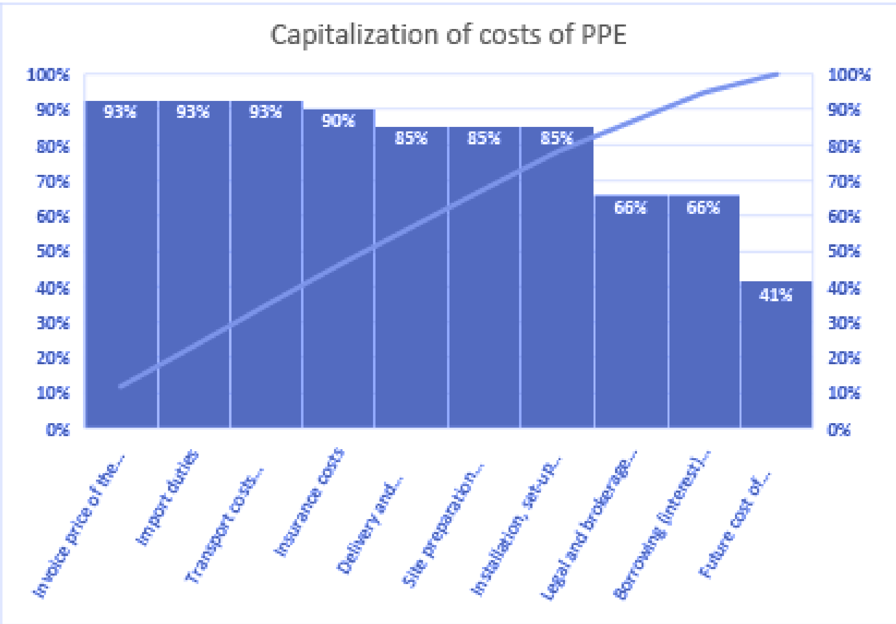
- the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

Paragraph 16 & 17 lists what constitutes as elements of cost including:

a) Its purchase price, including legal and brokerage fees, transportation, import duties, and nonrefundable purchase taxes, after deducting trade discounts and rebates;
b) Any directly attributable costs incurred to bring the asset to the location and operating condition as expected by management, including the costs of costs of employee benefits as per IAS 19 arising directly from the construction or acquisition of the item of PPE, site preparation, delivery and handling, installation, setup and testing; and
c) Estimated costs of dismantling and removing the item and restoring the site.
d) The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset (those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made).

In Ethiopia, many, if not most, reporting entities do not capitalize the last three. Capitalization of the last two are even unheard of.

Survey result:



ii. Subsequent costs

As per paragraphs 12-14, costs incurred subsequent to initial recognition of PPEs include:

- Costs of day-to-day servicing;
- Costs of regular repair and maintenance;
- Costs of part replacement; and
- Costs of regular major inspections.

The problems in accounting for these costs in Ethiopia are two-fold and contradictory. Some simply dump all these costs as periodic expenses while others follow the tax capitalization threshold disregarding the capitalization criteria of IAS 16, namely either increasing the useful life of the asset or improving its productivity or service delivery capability.

iii. Subsequent measurement (Para. 29-42)

After initial recognition, paragraph 29 requires an entity to choose either the cost model or the revaluation model (when fair value can be measured reliably) as its accounting policy and apply that policy to an entire class of PPE.

HISTORIC COST MODEL	REVALUATION MODEL
Cost Less: accumulated depreciation Less: accumulated impairment losses	**Fair value on revaluation date** Less: accumulated depreciation Less: accumulated impairment losses

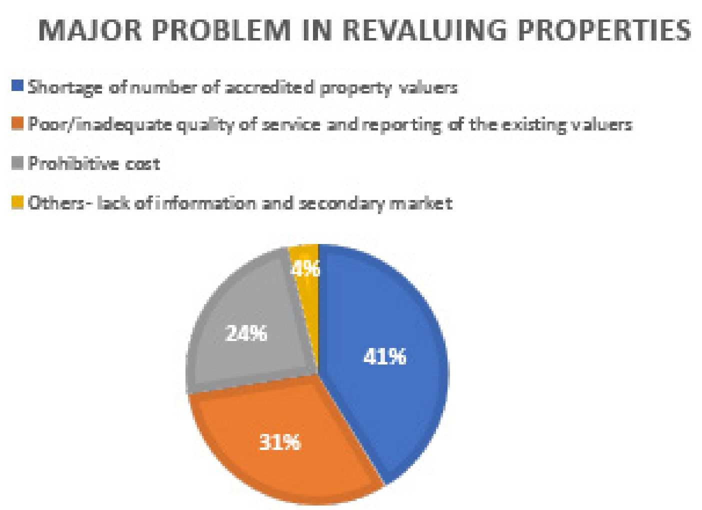
Revaluation shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period (para. 31).

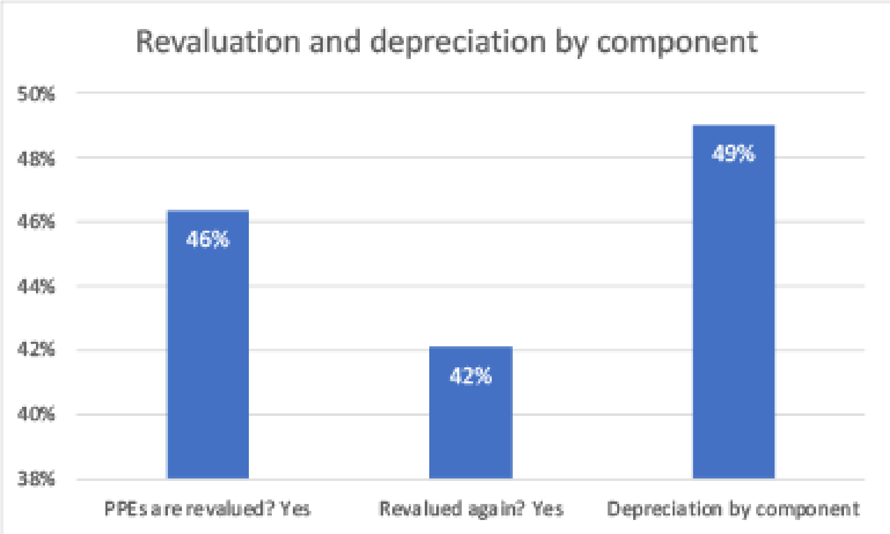
Note that measurement model is an accounting policy choice per class of asset and the same model shall be used for assets with similar nature and use in entity's operations.

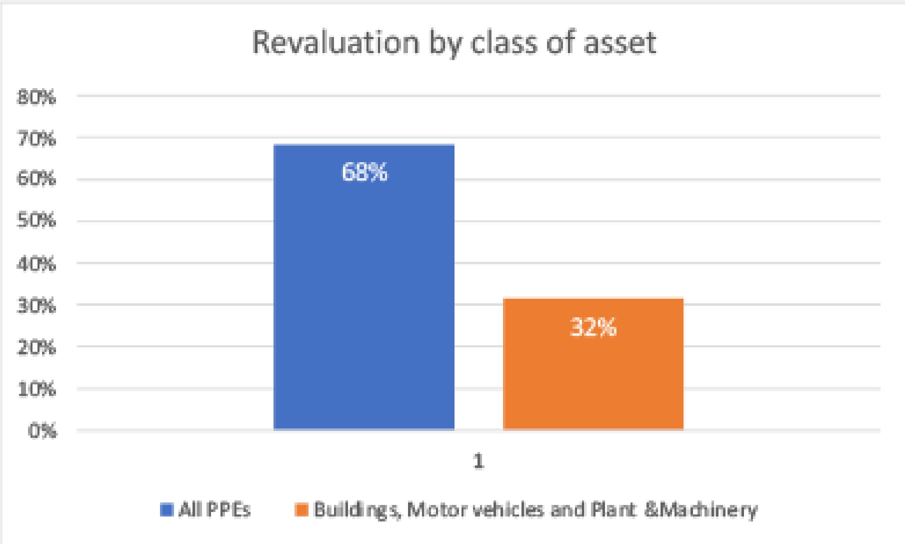
From my experience, the major problems in Ethiopia requiring immediate attention are:

a) Choice of the accounting policy to use cost or revaluation model usually does not follow the requirement and sprit of IAS 8; choosing the option producing relevant and reliable financial information to expedite users' decision-making process after consideration of all facts and circumstances.
b) Some reporting entities do not segregate classes of PPEs requiring revaluation; tendency to revalue all PPEs irrespective of their nature and price trend.
c) For those choosing revaluation model, there are tendency of forgetting the need for revaluation once done despite of the current sky-rocketing price increases in Ethiopia.

Survey result:







iv. Depreciation

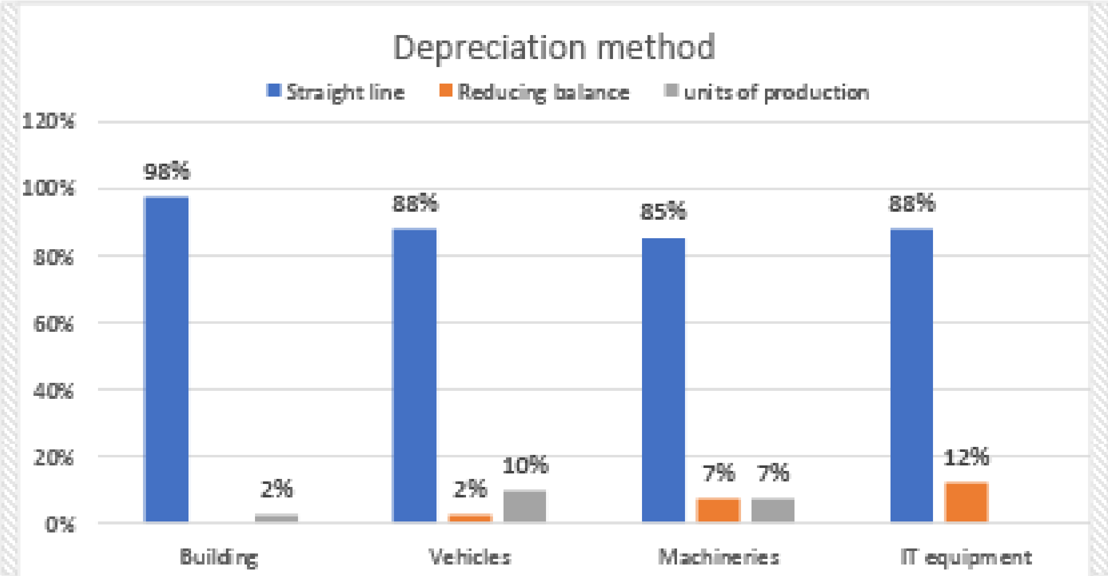
Each part of an item of PPE with a cost that is significant in relation to the total cost of the item shall be depreciated separately (para. 43). Depreciation for a period depends on:

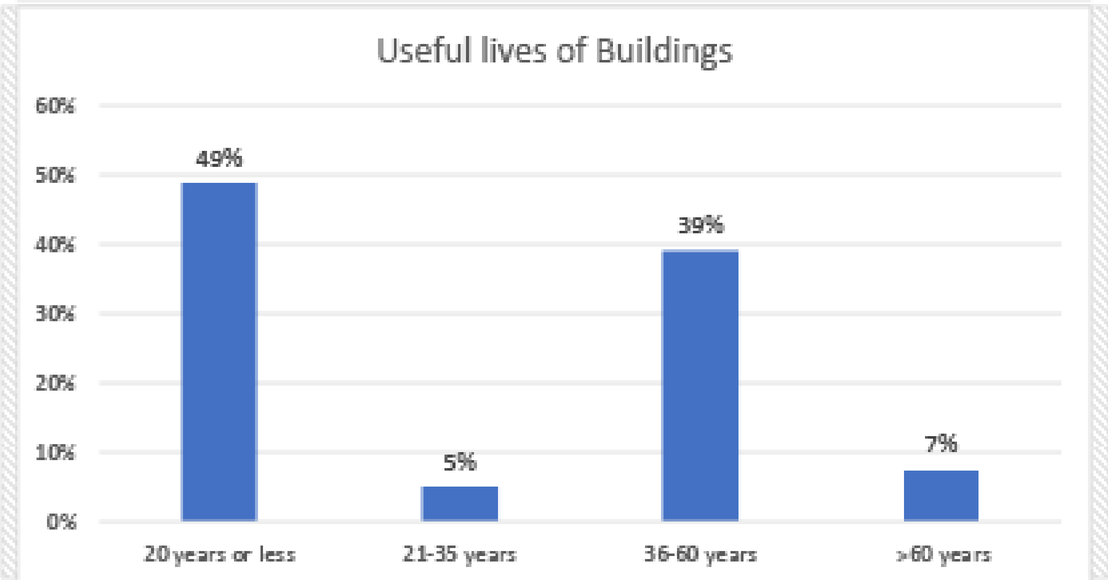
a) The depreciable amount- cost or revalued amount less related salvage/ residual value;
b) Depreciation method- straight line, reducing balance or units of production method;
c) Depreciation rate- wholly dependent on useful lives of the assets.

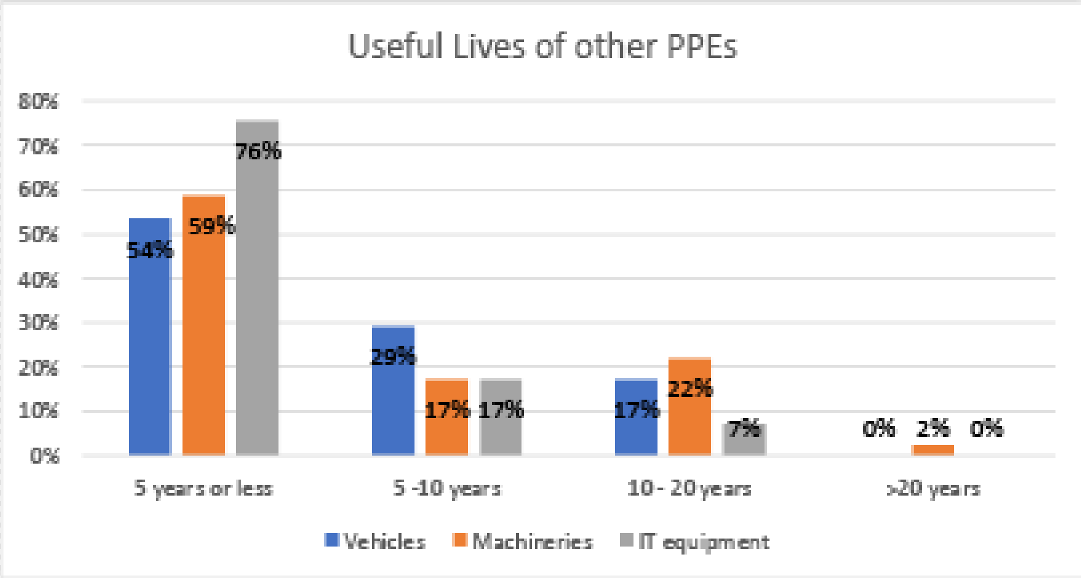
Practical experience shows there are problems somehow or rather in relation with all of the above.

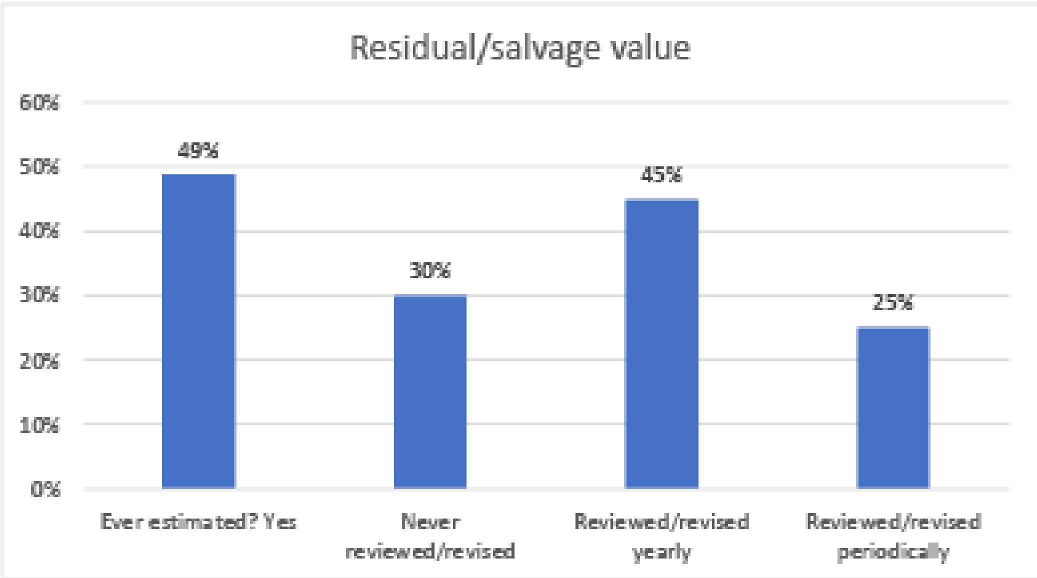
a) The depreciable amount- residual values are not estimated by most reporting entities;
b) Depreciation method- most reporting entities use methods allowed for tax purpose without due regard for the pattern in which the asset's future economic benefits are expected to be consumed by the entity , as required by the standard (para, 60);

c) Depreciation rate- most reporting entities useful lives allowed for tax purpose or even those who re-estimated appear to be not realistic of the assets.
d) Depreciation method, useful lives and residual values are not reviewed at least at each financial year-end as required by the standard (para. 51 & 61); and
e) Component approach for estimation of depreciation is not used by almost all reporting entities as required by the standard (para. 45-47).









3 Implementation Roadblocks

There are several factors that made Ethiopia's IFRS implementation difficult, if not impossible, the major ones being:

a) Shortage of appropriate internal and external experts and expertise including but not limited to:

i. Accredited and licensed property valuers (external);
From my viewpoint, there are paradoxical situation here. They are too few in numbers that they couldn't properly and professionally handle the revaluation assignments coming their way on one hand and as revaluation requests are too infrequent (till now, revaluations are done up on IFRS conversion only), they don't have sufficient job to handle on the other.

ii. Accredited and licensed actuarial valuers (external);
Practically, there are no accredited and licensed actuarial valuers in Ethiopia, probably until recently. Those few IFRS implementers who engaged actuaries did from Kenya resulting in incurring substantial cost in foreign currency and difficulty in exchanging information and quality control.

iii. Shortage of internal and external experts well versed in IFRS;
In Ethiopia, most finance professionals started dealing with IFRS issues only after promulgation of the standard as national financial reporting framework and at or very near to the IFRS implementation. Hence, given the number of entities required to implement IFRS, there are not sufficient number of external experts well versed in both theoretical and practical IFRS issues (consultants, trainers, etc). Besides, majority, if not all, of finance staffs of IFRS implementers (internal) took only introductory (eye-opening) trainings before being given to deal with IFRS implementation issues.

In truth, the extent to which reporting entities are complying with the requirements of IFRS heavily relies on their respective auditors' commitment and dedication in supporting/assisting their clients and enforcing the compliance.

b) Training and education system
   i. Only very recently government universities revised their curriculum and incorporated IFRS in their accounting education.
   ii. There are only few well-organized IFRS training centers and some trainees claim that majority of the trainings are more of theoretical than practical.
   iii. Some also claim that support and commitment by business owners and management to finance staffs' IFRS trainings.

c) Shortage of information
Obtaining relevant and reliable information for effective implementation of IFRS is also considered to be a hurdle. This is particularly paramount in connection with fair value measurement.

Survey results: