



BANK OF ZAMBIA

**OFFICE OF THE DEPUTY GOVERNOR - OPERATIONS**

January 10, 2006

**CB Circular No. 02/2006**

**To: All Commercial Banks and Non-Bank Financial Institutions**

**BANK OF ZAMBIA PRUDENTIAL GUIDELINES ON THE APPLICATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS**

**1.0 Introduction**

- 1.1 Following the directive by the Zambia Institute of Chartered Accountants (ZICA) that all corporate entities, including commercial banks and non-bank financial institutions registered and operating in Zambia, adopt the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) for reporting periods beginning on or after 1 January 2005, the Bank of Zambia herewith provides supervisory guidance to ensure that the financial statements are prepared within the existing regulatory framework.
- 1.2 The Bank of Zambia's authority in respect of financial reporting is drawn from the Banking and Financial Services Act (BFSA) which requires the financial statements to "contain what is necessary to present fairly, in accordance with generally accepted accounting principles consistently applied, the financial position of the bank or financial institution as at the end of the financial year to which it relates and the results of the operations and changes in the financial position of the bank or financial institution for that financial year".
- 1.3 The purpose of this circular therefore is to enhance the accounting framework such that financial statements produced by commercial banks and financial institutions incorporate the regulatory and prudential concerns of the Bank of Zambia.
- 1.4 Given that the Zambia Accounting Standards were not significantly different from the IFRSs, the Bank of Zambia has disallowed the optional exemptions IFRS 1.13 - 25 that are available when an entity prepares its first IFRS financial statements. This approach will ensure that the comparability of a financial institution from year to year and with other financial institutions is not made unnecessarily intricate.

## 2.0 Classification and Measurement of Financial Assets and Liabilities

### IFRS Treatment

- 2.1 There are four categories of financial assets and two categories of financial liabilities (*IAS 39.9*). IAS 39 restricts the ability to reclassify financial assets and financial liabilities to other categories. In this regard, reclassifications in or out of the fair value through profit and loss category are not permitted (*IAS 39.50*). Although reclassifications between the available-for-sale and held-to-maturity categories are possible (*IAS 39.51*), reclassifications of more than an insignificant amount of held-to-maturity investments before maturity would necessitate reclassification of all remaining such investments to available-for-sale (*IAS 39.52*) as all the entity's remaining held-to-maturity investments are deemed to be tainted (otherwise known as the "tainting rule"). An entity cannot reclassify from loans and receivables to available-for-sale. Complete classification of financial instruments is as shown in Appendix I.
- 2.2 IAS 39 permits entities to apply the fair value accounting to certain financial instruments that they designate at the time of purchase or origination. This accounting treatment is commonly known as the "fair value option". However, the IASB has stipulated that the fair value option can only be applied where (a) such designation eliminates or significantly reduces an accounting mismatch, (b) a group of financial assets, financial liabilities or both are managed and their performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy (*IAS 39.9B*), or (c) an instrument contains an embedded derivative that meets particular conditions (*IAS 39.12*).

### BOZ Prudential Approach

- 2.3 Commercial banks and financial institutions are expected to devise frameworks with regard to the estimation techniques and in particular the reference prices in order to come up with fair values of financial instruments. As a supervisor, the Bank of Zambia seeks to ensure that financial institutions follow sound accounting policies and practices. In order to achieve this, the Bank of Zambia will require that the following issues are considered before a financial institution avails itself of the fair value option. A financial institution must have risk management systems and related risk management policies and procedures to ensure that:
- (a) sound risk management objectives consistent with the risk management framework and overall risk appetite approved by the board of directors (or a committee of the board) are being met when the fair value option is used;
  - (b) appropriate valuation methods subject to Bank of Zambia approval are being used;
  - (c) fair values are indeed reliable for instruments in the fair value option category;
  - (d) policies related to the use of the fair value option and related valuation methodologies are being consistently applied and are being complied with throughout the bank; and
  - (e) appropriate information is provided periodically to senior management and the board of directors (or committees of the board) about the use of the fair value

option and its impact on the financial institution's financial condition and performance.

- 2.4 In addition, if the fair value option is used and non-derivative financial assets or liabilities (other than those held for trading) are designated as at fair value through profit or loss:
- (a) financial institutions would be required to report to the Bank of Zambia the impact of the use of the fair value option;
  - (b) all unrealised gains would not be recognised for the purpose of calculating regulatory capital; and
  - (c) commercial banks, through the Bankers Association of Zambia, their external auditors and the Zambia Institute of Chartered Accountants, may coordinate in formulation of the fair value models applicable to banks in Zambia. The Bank of Zambia stands ready to take part in such an exercise.
- 2.5 All financial institutions are encouraged to familiarise themselves with the contents of the Basel Committee on Banking Supervision consultative document, entitled "Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards," July 2005. The document is also available at the following internet address: [www.bis.org/publ/bcbs114.pdf](http://www.bis.org/publ/bcbs114.pdf).

#### ***Rationale***

*The Bank of Zambia approach is consistent with the approaches adopted by other regulatory agencies, particularly where information is limited as regards fair valuation and the lack of an active secondary market for financial instruments.*

### **3.0 Impairment and Uncollectibility of Financial Assets**

#### **IFRS Treatment**

- 3.1 A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognized (*IAS 39.59*).
- 3.2 The amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset is reduced either directly or through use of an allowance account and the amount of the loss is recognised in profit and loss account (*IAS39.63*).

- 3.3 The estimated recoverable amount is the net present value of the future cash flows expected from the asset, discounted using the original effective interest rate of the instrument. The fair value of collateral is taken into account when determining an asset's expected future cash flows (*IAS 39, E.4.8*).

**BOZ Prudential Approach**

- 3.4 The existing rules in Statutory Instrument No. 142 of 1996 (Classification and Provisioning of Loans Regulations) will be applied. However, the Bank of Zambia will undertake an appropriate amendment of SI 142 of 1996 as need arises.

*Rationale*

*The Bank of Zambia approach recognises the difficulty associated with the estimation of future cash flows to determine the present value of assets. The BOZ approach is also relatively more prudent than IAS 39 in view of the high incidences of credit losses.*

**4.0 Recognition of Interest Income on Impaired Assets (Non-accrual Loans)**

**IFRS Treatment**

- 4.1 Once a financial asset has been written down to its estimated recoverable amount as a result of impairment loss, interest income is recognised thereafter based on the rate of interest that was used to discount the future cash flows for the purpose of measuring the recoverable amount (*IAS 39, AG93*).
- 4.2 Impairment of accrued interest receivable is recorded as a bad debt expense, consistent with impairment losses on loans and receivables.

**BOZ Prudential Approach**

- 4.3 The Bank of Zambia will continue to use Statutory Instrument 142 of 1996 (Classification and Provisioning of Loans) that requires that when a loan is placed in "non-accrual" status all previously accrued but uncollected interest taken in as income is reversed.

*Rationale*

*The Bank of Zambia approach recognizes that SI 142 of 1996 takes precedence over the IFRS.*

**5.0 Accounting Treatment for Hedges**

**IFRS Treatment**

- 5.1 IAS 39 identifies three types of hedge transactions and specifies their accounting treatment. The three types are:
- (a) Fair value hedges<sup>1</sup>;
  - (b) Cash flow hedges<sup>2</sup>; and

<sup>1</sup> *Fair value hedge*: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss (*IAS 39.86a*)

(c) Hedge of a net investment<sup>3</sup>.

- 5.2 In practice, a fair value hedge is used to offset fair value changes in an asset, liability or firm commitment. Cash flow hedges are used to hedge cash flows of a forecasted transaction or an existing floating rate asset or liability, which would be measured at amortised cost.
- 5.3 IAS 39 introduces specific qualification requirements for these types of hedge transactions. It requires that the hedging relationship be defined by designation and properly documented, be reliably measurable and actually effective at inception of the hedge transaction and throughout its life. A hedge is regarded effective if 80 to 125 per cent of the hedged risk on a hedged item is offset by changes in the fair value or cash flows of the hedging instrument. Ineffective hedges are recognised immediately in the profit and loss account.
- 5.4 In the case of fair value hedges, fair value gains or losses on the hedging instrument as a result of market price changes are recognised in profit and loss, together with the offsetting change in the fair value of the hedged item. The effect is that changes in fair value on both the hedged item and the hedging instrument are recognised in the same period and any ineffectiveness of the hedge is recognised in profit and loss.
- 5.5 In the case of cash flow hedges, however, IAS 39 accounting rules require that the portion of the fair value gain or loss on the cash flow hedging instrument that is determined to be an effective hedge to be recorded in equity, with no corresponding loss or gain recorded against the hedged exposure. As a result, the movements in the hedging instrument and the hedged item do not offset each other. This asymmetry in the treatment of cash flow hedges is a prudential concern because it leads to spurious volatility in accounting measures of equity and regulatory capital.
- 5.6 Paragraph 98 of IAS 39 discusses the accounting treatment of a cash flow hedge of a forecast transaction that results in the recognition of a non-financial asset or liability. Two optional accounting treatments are allowed for reclassifying the gains or losses on the hedging instrument that were previously recorded in equity:
- (a) The gains or losses remain in equity and are reclassified into income in the same period during which the asset acquired or liability assumed affects income (e.g., through depreciation of the asset); or
  - (b) The gains or losses are reclassified out of equity and recognised as part of the initial cost or carrying amount of the asset or liability.

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<sup>2</sup> *Cash flow hedge*: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss (IAS 39.86b).

<sup>3</sup> *Hedge of a net investment in a foreign operation*: a monetary item that is receivable or payable to a foreign operation, for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation (defined in IAS 21.15). A hedge of a net investment in a foreign operation is accounted for similarly to cash flow hedges (IAS 39.102).

### **BOZ Prudential Approach**

- 5.7 The Bank of Zambia will not allow banks and financial institutions to include cumulative gains and losses on cash flow hedges that are recognised directly in equity from the definition of Tier 1 and Tier 2 capital. This is in line with the international prudential best practice as recommended by the Basel Committee.
- 5.8 In addition, in the case of a cash flow hedge of a forecast transaction that subsequently results in the recognition of a non-financial asset or liability, the BOZ will require that any gains or losses on the hedging instrument that were recognised in equity must be removed from equity and included in the initial carrying amount of the non-financial asset or liability.

#### *Rationale*

*The Bank of Zambia approach recognizes that the asymmetric treatment of cash flow hedges may cause spurious volatility in computing equity and regulatory capital because movements in the hedging instrument and hedged item may not offset each other.*

### **6.0 Available-for-Sale Assets**

#### **IFRS Treatment**

- 6.1 Under IAS 39, available-for-sale assets are those non-derivative financial assets that are designated as available-for-sale but not classified as loans and receivables, held-to-maturity investments or financial assets designated at fair value through profit and loss (IAS 39.9).
- 6.2 The available-for-sale category can include equities, debt securities, loans and receivables. Available-for-sale assets are measured at fair value with gains and losses recognised directly in equity using a revaluation reserve. This revaluation reserve is transferred to the profit and loss account when the asset is sold or impaired.

#### **BOZ Prudential Approach**

- 6.3 The Bank of Zambia's position is to disallow the inclusion in regulatory capital of the net revaluation surplus on available-for-sale financial assets.

#### *Rationale*

*The Bank of Zambia approach recognizes the difficulty associated with realizing short term gains for financial assets which are not traded in active and liquid secondary markets.*

### **7.0 Accounting Employee Benefits under IAS 19**

#### **IFRS Treatment**

- 7.1 The objective of IAS 19 is to prescribe the accounting and disclosure requirements for employee benefits. An entity is expected to recognize a liability when an employee has provided a service in exchange for employee benefits to be paid in the future and an expense when the entity consumes the economic benefit arising from service provided by the employee in exchange for employee benefits.
- 7.2 There are two main types of post-employment benefit plans, the defined contribution plan and the defined benefit plan. Accounting for defined contribution

plans is straightforward because the reporting entity's obligation for each period is determined by the amounts to be contributed for that period. However, accounting for defined benefit plans is more complex because actuarial assumptions are required to measure the obligation and the expense and there is a possibility of actuarial gains and losses. Moreover, the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service.

- 7.3 IAS 19 permits either of the two to recognize the asset/liability in full through the income statement or to defer the gain or loss and recognize "as a minimum, a specified portion of the actuarial gains or losses that fall outside a 'corridor' of plus or minus 10%" around the best estimate of post employment benefit obligations (IAS 19.95).

**BOZ Prudential Approach**

- 7.4 The Bank of Zambia will disallow any defined benefit plan actuarial gain for the purpose of computing regulatory capital. This is because the determination of ownership of a gain is not a straight forward issue and will depend on the specific terms of the trust deed. Further, the fund surplus might not be liquid enough to allow the employer cushion its losses against it and hence form part of regulatory capital.
- 7.5 In contrast, the Bank of Zambia believes it is appropriate for an employer sponsor to deduct from regulatory capital in full any deficit in a defined benefit plan. This reflects the responsibility of the employer sponsor to ensure that the plan is in a position to meet its promises to beneficiaries.

***Rationale***

*The Bank of Zambia approach recognizes that actuarial gains are subject to uncertain assumptions, especially in respect to the fair value of the fund assets as well as the future liabilities.*

**8.0 Conclusion**

- 8.1 The Bank of Zambia recognizes that evolving business practices require that the recognition, measurement, presentation and disclosure of financial assets and liabilities are also up-to-date. In view of this, the Bank of Zambia is committed to reviewing the regulatory requirements to take into account the developments in the accounting standards.
- 8.2 The Guidelines take effect from the financial statements for the year ending 31 December 2005.



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APPENDIX I

Table 1: Financial Assets

Category	Defining Characteristics	Prescribed Accounting Treatment
Financial assets at fair value through profit or loss (includes financial assets that are held-for-trading and those that are designated at inception)	Held-for-trading - purchased with the intention of making a profit from short-term market fluctuations; part of a portfolio of identified financial assets that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; a non-hedging derivative asset. Designated includes any financial asset that is designated as at "Fair Value through profit and loss" on initial recognition.	Fair value. Gains and losses on revaluation recognized in profit or loss (income statement).
Held-to-maturity	Fixed or determinable payments; fixed maturity with positive intent and ability to hold to maturity	Amortised cost
Loans and Receivables	Fixed or determinable	Amortised cost



	payments; not quoted in an active market	
Available-for-sale	All other non-derivative financial assets.	Fair value. Unrealized gains or losses recognized in a separate category of equity. Realized changes reported in profit or loss.

Table 2: Financial Liabilities

Category	Defining Characteristics	Prescribed Accounting Treatment
Financial liabilities at fair value through profit or loss (includes financial liabilities that are held-for-trading and those that are designated at inception)	Held-for-trading - incurred to make or gain from short-term market fluctuations (including all non-hedging derivative liabilities). Designated financial liability is a liability that is designated as at "Fair Value through profit and loss" upon initial recognition.	Fair value. Adjustment recognized in profit or loss (income statement)
Other liabilities	All other liabilities	Amortised cost