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LEGAL BASIS FOR IMPLEMENTATION OF THE IFRS 9 REPORTING STANDARD AND ITS TAX IMPLICATIONS FOR NIGERIAN ENTITIES

Introduction

On July 24, 2014, the International Accounting Standard Board **("IASB"**) launched the International Financial Reporting Standard 9 **("IFRS 9")** as the global accounting standard for the measurement and classification of financial instruments in the financial statements of corporates. The IFRS 9, which became effective for annual periods beginning on or after January 1, 2018 (with early application permitted) replaced the International Accounting Standard 39 **("IAS 39")** which was in operation between 2001 and 2017.

As from the date of its publication, the IFRS 9 became available for adoption by national accounting standard-setters around the world in order to effectively achieve the G20-endorsed objective of global accounting standards. Nigeria adopted the IFRS reporting standards in 2012, and was, by implication, one of the jurisdictions expected to migrate from the IAS 39 regime to IFRS 9.

IAS 39 was criticized by many auditors and users of financial statements for being complex and not easily adopted and user friendly. Essentially, the IAS 39 regime was plagued by several shortcomings, such as (i) complex and rules-based classification methods for financial instruments, (ii) multiple impairment models leading to avoidable credit crunch, (iii) inability to reflect economic and business realities, and (iv) failure to make adequate provisions for efficient credit risk capture because it unnecessarily deferred recognition of credit losses on loans and receivables until too late in the credit cycle. It was therefore identified as a major contributor to the 2008 global financial crisis.

In response to these criticisms, the IFRS 9 was launched, and it seeks to introduce significant reforms in the areas of classification and measurement of financial assets, hedge accounting transactions, and disclosure requirements, which have significant tax implications for business entities[1]; particularly in the areas of tax deductibility of impairment losses and tax treatment of financial instruments at fair value through profit or loss.

This article reviews the legal basis for implementation of the IFRS 9 and its tax implications for entities carrying on business in Nigeria. It also considers the reforms introduced by the IFRS 9 regime and possible challenges to implementation of the accounting standard, as well as the likely implications on financial assets management for public entities operating in Nigeria.

1. The IAS 39 regime and the reforms introduced by IFRS 9

Under IAS 39, financial assets[2] were classified into one of the following four categories:

(i) financial assets at fair value through profit or loss;
(ii) available for sale financial assets;
(iii) loans and receivables; and
(iv) held-to-maturity investments.[3]

These categories were used to determine how a financial asset was recognized and measured in the financial statements of an entity.

On the other hand, IFRS 9 introduced a logical classification and measurement model for financial assets. Key features of the new accounting standard include the following:

- It replaced the impractical IAS 39 "incurred credit loss" impairment model with a pragmatic "expected credit loss" impairment model;
- It entrenched a substantially reformed approach to hedge accounting transactions, which aligns hedge accounting principles more closely with business risk management; and
- It successfully addressed the shortcomings of IAS 39 by specifying a coherent process for classification and measurement of financial assets, assessment of financial liabilities, and determination of contractual rights for the buying and selling of certain non-financial items.

[1] *IFRS 9 prescribes new guidelines for the classification and measurement of financial assets and liabilities, and makes fundamental changes to the methodology for measuring impairment losses, by replacing the problematic IAS 39 "incurred loss" model with a forward-looking "expected loss" model.*

[2] *In global financial accounting, financial assets generally include cash, investments in equity, and contractual rights to receive cash or other financial assets from other business entities. Financial assets also include trade receivables, loan receivables, equity investments, bond investments, fixed deposits, investments in treasury bills and commercial papers, amongst other money market instruments.*

[3] *See IAS 39.45*

Fundamentally, it requires that when an entity first recognizes a financial asset, it classifies it based on the entity's business model for managing the asset and the asset's contractual cash flow characteristics. Ordinarily, these are done distinctly as (i) Amortized cost, (ii) Fair value through other comprehensive income, and (iii) Fair value through profit or loss.

2. Legal basis for implementation of IFRS 9 in Nigeria

The Financial Reporting Council of Nigeria ("**FRCN**"), established under Section 1(1) and (2) of the ***Financial Reporting Council of Nigeria (Establishment) Act 2011***[4] (the "**FRCN Act**"), replaced the defunct Nigerian Accounting Standards Board responsible for developing and publishing accounting and financial reporting standards to be observed in the preparation of financial statement of public interest entities (**"PIEs"**)[5] in Nigeria. PIEs include quoted and unquoted companies and also governments, government organizations, and not-for-profit entities that are required by law to file returns with regulatory authorities.

FRCN is empowered to enforce and approve enforcement of compliance with accounting, auditing, corporate governance, and financial reporting standards[6] in Nigeria[7] and to require entities[8] to provide real time disclosures on material changes in financial conditions or operations.[9]

Following enactment of the FRCN Act in 2011, the IFRS standards were adopted in Nigeria on January 1, 2012 as part of measures to improve financial reporting practices, transparency, and disclosures. The adoption of the IFRS standards implies that all revisions to existing IFRS standards, as well as new accounting standards issued by the IASB, are now required to be adopted by all financial reporting entities in Nigeria[10]. Indeed, sections 8 and 52 of the

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[4] *Cap. F42 Laws of the Federation of Nigeria ("LFN") Annual Supplement 2011.*

[5] *"Public interest entities" are defined in section 77 of the FRCN Act to mean governments, government organizations, quoted and unquoted companies, and all other organizations which are required by law to file returns with regulatory authorities, and this excludes private companies that routinely file returns only with the Corporate Affairs Commission ("CAC") and the Federal Inland Revenue Service ("FIRS").*

[6] *"Financial reporting standards" is defined in section 77 of the FRCN Act to mean accounting, auditing, actuarial, and valuation standards issued by the FRCN under the FRCN Act.*

[7] *See section 7(2)(a) of the FRCN Act.*

[8] *"Entity" is defined in section 77 of the FRCN Act to mean any person or body of persons, whether incorporated or unincorporated.*

[9] *See section 7(2)(h) of the FRCN Act.*

[10] *The Central Bank of Nigeria ("CBN") had by a notice dated December 20, 2016 (CBN public letter referenced BSD/DIR/GEN/IFR/09/130), issued a guidance note to banks and discount houses on the implementation of IFRS 9 in the Nigerian banking sector. This was followed by another CBN notice issued on October 18, 2018 (CBN public letter referenced BSD/DIR/GEN/LAB/11/027), clarifying its expectations regarding the regulatory treatment of accounting provisions under the IFRS 9 reporting standard, as well as recommending transitional arrangements to cushion the impact of IFRS 9 on January 1, 2018, being the initial date of application of the IFRS 9 regime. Thereafter, the CBN issued another notice on March 5, 2019 (CBN public letter referenced OFISD/DIR/GEN/IFR/020/101), clarifying its expectations regarding implementation of the IFRS 9 regime by all other financial institutions in Nigeria.*

FRCN Act provide statutory approval for the adoption and enforcement of IFRS and IASB-approved accounting standards in Nigeria.

3. Tax implications of IFRS 9 implementation for Nigerian entities

The adoption and implementation of IFRS 9 has significant tax implications for entities carrying on business in Nigeria, in particular, in the areas of tax deductibility of impairment losses and tax treatment of financial assets at fair value through profit or loss.

(i) Tax deductibility of impairment losses

The seeming logical approach of IFRS 9, which seeks to recognize credit losses on loans and other financial instruments, may occasion a major tax concern for entities operating in Nigeria. The new regime introduced "expected loss" impairment model, which requires entities to account for expected credit losses from when financial instruments are first recognized, and to recognize full lifetime expected losses on a timely basis. This effectively addresses the delayed recognition of credit losses on loans and other financial instruments under the IAS 39 "incurred loss" impairment model.

Whilst this innovation in the IFRS 9 regime is expected to ordinarily improve tax deductibility of bad and doubtful debts in Nigeria, there may be a practical implementation challenge, in view of the discretionary powers vested in the FIRS under section 24(f) of the ***Companies Income Tax Act ("CITA")***[11], which sets out the parameters for tax deductibility of bad and doubtful debts and, provides a legal basis for FIRS' established practice in relation to the allowance of impairment losses for tax deduction purposes.

Under the repealed IAS 39, financial assets measured at amortized cost were required to be subjected to annual impairment review, with the aim of ascertaining if any impairment loss has occurred in the relevant accounting period. This was the infamous "incurred loss" impairment model. Recognition of impairment loss was limited to situations, where loss events impacting the recoverability of estimated future cash flow from financial assets had in fact occurred. Thus, objective evidence that the cash flow relating to a financial asset may have become irrecoverable is necessary.

The IFRS 9 "expected loss" model for assessing impairment of financial assets measured at amortized cost, allows business entities to recognize impairment loss on a financial asset from the first day of entering into the contractual arrangement upon which the impairment may occur; without waiting for the actual occurrence of the relevant loss event. This model effectively allows a business entity to reflect impairments of its financial assets on its financial statements on an expected credit loss basis, without waiting till when the relevant credit loss actually occurs.

[11] *Cap. C21 LFN 2004 (as amended in 2007)*

The IFRS 9 impairment requirements recognize 12-month and lifetime expected credit losses for all financial instruments for which there has been a significant increase in credit risk since after an initial recognition based on stage allocation. The IFRS 9 expected credit loss regime also incorporates forward-looking macroeconomic forecast in its estimation and may be assessed on individual or collective basis. This impairment model may result in the overstatement of impairment charges, as it will incorporate not only incurred credit losses but also expected credit losses.

The tax implication of this model is that, unlike what was obtainable under the IAS 39, the new regime attracts more scrutiny of specific impairment losses in the company's profit-before-tax in an accounting year. This may cause the FIRS to disallow such impairment losses for tax purposes, relying on the discretionary powers of the FIRS, under section 24(f) of the CITA, in relation to the treatment of bad and doubtful debts.

For the purpose of ascertaining the profits or loss of any company for any period from any source chargeable to tax under the CITA, bad debts incurred in the course of a trade or business (proved to have become bad during the period for which the profits are being ascertained) and doubtful debts (to the extent that they are respectively estimated to the satisfaction of the FIRS to have become bad during the said period) are deductible. Pursuant to the provisions of section 24(f)(iii) of the CITA, notwithstanding that such bad or doubtful debts were due and payable before the commencement of the said period, such deductibility shall be permissible, in so far as same is proven, to the satisfaction of the FIRS that the debts in respect of which a deduction is claimed were either included as a receipt of the trade or business in the profits of the year within which they were incurred; or were advances not falling within the provisions of the trade or business in the profits of the year within which they were incurred; or were advances not falling within the provisions of section 23(1)(e) of the CITA[12], made in the course of normal trading or business operations.

Under the defunct IAS 39 regime, the FIRS established the practice of assessing the tax deductibility of impairment charges on an individual and collective basis. In this way, the FIRS allowed specific impairment on individually significant non-performing loans and disallowed deduction of collective impairment on performing and individually insignificant non-performing loans. This practice was based on the discretionary powers vested in the FIRS, which effectively allows tax-deductibility of bad or doubtful debts incurred in relation to

[12] *Section 23(1)(e) of the CITA exempts from tax, the profits of any company being a trade union registered under the Trade Unions Act in so far as such profits are not derived from a trade or business carried on by such trade union.*

ascertaining and computing a company's profits for any relevant accounting period, only to the extent they are estimated, to the FIRS' satisfaction, to have become bad or doubtful.

Conversely, the IFRS 9 regime requires entities to objectively assess their trade receivables for impairment at a balance sheet date, while charging the loss thereon to the income statement for the relevant accounting period. The rationale for the global trend and convention in relation to bad and doubtful debts is to provide prudent accounting guidelines to entities reporting revenue for a certain period and perhaps, to ensure that these entities are not burdened with paying taxes on uncollected revenue. Clearly, the trend may have a practical implementation challenge in Nigeria, which may be attributable to the FIRS' established practice of disregarding "expected loss" impairment projections made by companies in their financial statements, and preference of its subjective approach of allowing deductibility of bad and doubtful debts for tax purposes. In effect, the IFRS 9 "expected loss" impairment model is therefore likely to occasion greater volatile impairment losses on the capital ratios of companies operating in Nigeria. This model may in our view potentially result in overstatement of impairment charges, which may likely be disallowed by the FIRS for tax deductibility purposes.

Whilst Nigerian companies are permitted to deduct bad or doubtful debts from their taxable income and profits for any relevant accounting year, it is clear that the FIRS, in practice, has consistently relied on its discretionary powers under section 24(f) of the CITA to impose stringent conditions, as prerequisites for companies to qualify to deduct tax in respect of bad and doubtful debts. This is more so, due to the tendency of the FIRS to interpret the provisions of the CITA in a manner that will likely prevent taxable companies from claiming deduction on accrued impairment losses for relevant accounting periods. In our view, FIRS should exercise its discretionary powers in a more objective manner in order to ensure fairness and easy compliance. In March 2013, FIRS issued a circular on the Tax Implications of the Adoption of International Financial Reporting Standards (the "**Circular**")[13]. In the Circular, financial instruments classified as loans and receivables are to be treated in line with the provisions of relevant tax laws[14]. It also provides that impairment losses on individual financial assets classified as loans and advances shall be subject to section 20 of the CITA.[15]

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[13] *The FIRS Circular was issued pursuant to the provisions of section 8 of the FIRS (Establishment) Act 2007 (the "FIRS Act") to provide direction to all revenue staff, tax practitioners, tax consultants, taxpayers, and the general public on the tax implications of the adoption of the IFRS reporting standards in Nigeria (see the preamble to the FIRS Circular.). Section 8 of the FIRS Act provides generally for the functions of the FIRS, which include the power to specify, from time to time, the form of returns, claims, statements and notices necessary for the due administration of the powers conferred on it by the FIRS Act; particularly the power to issue rules and guidelines for the purpose of implementing auditing and accounting standards (see section 8(2) of the FIRS Act.).*

[14] *See paragraph 26.3 of the IFRS Circular.*

[15] *See paragraph 26.15 of the IFRS Circular. Section 20 of the CITA provides for the mode of taxation of Nigerian dividends received by companies other than Nigerian companies or foreign companies carrying on business in Nigeria. Accordingly, while*

The IFRS 9 "expected loss" impairment model which requires entities to objectively assess their trade receivables for impairment at a balance sheet date, while charging the loss thereon to their income statement for the relevant accounting period, will operate to ensure that corporate entities are not burdened with paying taxes on uncollected revenue; if applied fairly by the FIRS.

(ii) Tax treatment of financial instruments at fair value through profit or loss

With regard to the recognition and measurement of financial instruments under IFRS 9, paragraph 26.1 of the FIRS Circular provides that financial instruments classified at fair value through profit or loss held for trading or short-term profit-taking, such as derivatives, are revenue in nature and therefore liable to company income tax (to the extent they are not specifically exempted from tax) under the CITA. It also provides that the transaction will be taken as a separate line of business except where the taxpayer is already engaged in the same line of business.[16]

paragraph 26.15 of the FIRS Circular refers to section 20 of the CITA, we believe that the reference was made in error and that the FIRS Circular intended to refer to section 24(f) of the CITA.

[16] *Paragraph 26.14 of the FIRS Circular further provides that the FIRS will ignore all fair values assigned to financial instruments, and at disposal, the historical cost will be used as the basis for tax computation.*

The *Companies Income Tax (Exemption of Bonds and Short-Term Government Securities) Order 2011* (the "**CIT Order**"), which came into force on January 2, 2012, exempts income earned from government and corporate bonds/short-term securities from company income tax. In like manner, the *Value Added Tax (Exemption of Proceeds of the Disposal of Government and Corporate Securities) Order 2011* (the "**VAT Order**"), which came into force on January 2, 2012, exempts proceeds from the disposal of short-term government and corporate bonds/securities from value added tax.[17]

The exemptions provided in the VAT and CIT Orders are only valid for a period of 10 years from January 2, 2012. To the extent that the dispensation provided in the VAT and CIT Orders should lapse on January 1, 2022, it would appear that income earned from such transactions after January 1, 2022 will be subject to tax at the appropriate CIT or VAT rates. However, the tax exemption of income earned from bonds issued by the Federal Government of Nigeria ("**FGN**") under the CIT and VAT

[17] *The provision may also be cited as* Paragraphs 10 and 11 of the First Schedule to the Value Added Tax Act, Cap. V1 LFN 2004 (as amended in 2007).

Orders will continue to apply after January 1, 2022.

Regarding income derived from long-term investment securities classified as financial assets held at fair value through profit or loss, the question will turn on whether such income will be treated as revenue subject to company income tax at the rate of 30% or regarded as capital gains subject to capital gains tax at the rate of 10%. It seems the FIRS has taken the view which is consistent with applicable case law that income derived from such investments will be treated as capital gain, subject to capital gains tax at the rate of 10%.[18]

It is noteworthy that section 30(1) of the CGT Act provides that gains accruing to a person from a disposal by him of Nigerian government securities, stocks, and shares shall not be chargeable gains under the CGT Act. "Nigerian government securities" is defined in the CGT Act to include Nigerian treasury bonds, savings certificates, and premium bonds issued under the Savings Bonds and Certificates Act[19].

[18] *Capital gains tax is charged in accordance with the provisions of the Capital Gains Tax Act, Cap. C1, LFN 2004 (the "CGT Act"). Paragraph 26.2 of the FIRS Circular provides that financial instruments classified as held-to-maturity instruments, such as debt securities and mandatory redeemable preference shares, are capital instruments. Consequently, capital gains tax shall apply to gains derived from the disposal of such instruments, except for gains exempted by relevant provisions of the CGT Act, and applicable regulations on the point. See also, the case of* Citibank Nigeria Ltd. v FIRS (2017) 30 TLRN 40

[19] *Section 30(2), CGT Act.*

Conclusion

In our view, the FIRS 9 regime has both legal and tax implications for business entities operating in Nigeria, particularly, those with substantial interest in financial instruments.

The potential challenges identified above notwithstanding, we hold the view that adoption of the IFRS 9 is not all doom and gloom for Nigerian businesses. Some recognized benefits that will flow therefrom include the now permitted deductibility of impairment losses in the financial statements of corporates, as well as the treatment of financial assets at fair value through profit or loss.

However, for businesses to access these benefits, it is imperative for the FIRS to exercise its discretionary powers (pursuant to section 24(f) of the CITA) with respect to treatment of bad and doubtful debts, in a manner that will give effect to the underlining and overarching objectives of the IFRS 9. We remain optimistic and are on the look out to see how IFRS 9 will help reporting obligations of Nigerian businesses and entities.

The Grey Matter Concept is an initiative of the law firm, Banwo & Ighodalo.

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