IFRS 9 Financial Instruments-Possible Implementation challenges

Agenda

❖Adoption permutations

❖Challenges in classification/business model/financial assets and financial liabilities

❖Measurement- low interest loans and internal transaction costs

❖Subsequent measurement – determination of fair value

❖Accounting for fee income

❖Determination of impairment

Practical implications - adoption

- ❖Until the effective date of IFRS 9 (2014) the following permutations of IFRS 9 and IAS 39 are possible
  - ❖Apply only IAS 39
  - ❖Apply IAS 39 and early adopt the own credit risk presentation of IFRS 9
  - ❖Applying only IFRS 9 (2009)
  - ❖Applying IFRS 9 (2009) and early adopting the own credit risk presentation of IFRS 9 (2010)
  - ❖Applying IFRS 9 (2010)
  - ❖Applying IFRS 9 (2013), but electing to apply IAS 39 for all hedge accounting
  - ❖Applying IFRS 9 (2013), including the new general hedging model
  - ❖Applying IFRS 9 (2014) but electing to apply IAS 39 for all hedge accounting, and
  - ❖Applying IFRS 9 (2014), including the general hedging of IFRS 9 (2013)

Practical implications - Classification

- ❖Classification of equity and financial liabilities- preference shares, classes of shares having special terms and conditions.
- ❖Classification determines how the interest/dividends will be accounted for
- ❖Classification of financial assets- One has to consider the following options based on the business model
    - ❖Held –to-collect business model-Amortized cost
    - ❖Both held to collect and for sales business model -Fair value through OCI
    - ❖Other business model-Fair value through profit or loss

Business model assessment

❖To determine the classification into amortised cost, FVOCI or FVTPL an entity needs to identify and assess the objective of the business model in which the asset is held.

❖The challenge is to ensure that management is clear on their intentions when they acquire assets i.e. Held to collect (amortised cost), both held to collect and for sale (FVOCI) and other business models e.g. Trading, managing assets on a fair value basis, maximising cash flows through sale (FVTPL)

❖The objective of the entity's model is not based on management's intentions with respect to an individual instrument, but rather it is determined at a higher level of aggregation.

Business model assessment

❖The assessment needs to reflect the way the entity manages its business or businesses;

❖A single reporting entity may have more than one business model for managing its financial instruments;

❖It may be appropriate to separate a portfolio of financial assets into sub portfolios;

❖Judgement is required in determining the business model as there is no threshold for the frequency or significance of sales that may occur.

Reclassification

❖The classification of financial assets depends on the way in which they are managed within a business model and not solely on the objective of the business model itself;

❖Changes in the way that assets are managed within the business model e.g. increased frequency of sales will not result in the reclassification of existing assets but may result in newly acquired assets being classified differently.

Measurement

- ❖Treatment of transaction costs –internal costs – the only internal transaction costs to be included in the initial measurement of a financial instrument are commissions, bonuses and other payments that are made to employees only on completion of each individual transaction

- ❖Low interest and interest free loans – in most cases, the fair value of a financial instrument on initial recognition will be equal to its cost.

- ❖ However , sometimes interest free or low interest loans are granted as a staff benefit.

- ❖The fair value can be measured as the present value of the expected future cash flows discounted using a market rate;

Measurement

❖Intra-group low interest and interest free loans –when low interest or interest free loans are granted to subsidiaries, the effect of discounting is eliminated on consolidation.

❖Therefore, the discounting will be reflected only in the financial statements of the subsidiary and any separate financial statements of the parent;

❖Situation of further complicated when there are no stated terms of repayment i.e. when and the value. In such cases consideration should be given to whether classification as a liability is appropriate.

Subsequent measurement

❖**Fair value –** challenges in determining fair value/complexities;

❖**Amortized cost-** the effective interest method is used for amortizing premiums, discounts and transaction costs for both financial assets and liabilities. Interest is recognized in the period in which it relates regardless of when it is to be paid.

❖ Therefore interest is recognized in the period in which it accrues even if payment is deferred.

❖Effective interest rate calculation- tendency to equate this to straight line method.

❖EIR includes all fees paid or received, transaction costs and all premiums or discounts

Fee income

❖Recognition of revenue for fees depends on the nature of the fees and the basis of accounting for any associated financial instrument.

❖It is necessary to distinguish between fees that are an integral part of the effective interest rate of an associated financial instrument, fees that are earned as services are provided and fees that are earned on the execution of a significant act.

Fee income

- Fees earned in relation to the recognition of a financial asset result in an adjustment of the effective interest rate e.g. origination/commitment fees, compensation for transaction costs and appraisal fees;

- **Fees not integral to effective interest rate –** some financial service fees are not an integral part of the effective yield of an associated financial instrument and are therefore recognized in accordance with IFRS 15 e.g. fees charged for servicing a loan, loan syndication fees for an entity that arranges a loan but retains no part of the loan package etc

Impairment

- **IFRS 9** is an expected loss model meaning it is not necessary for a loss event to occur before an impairment loss is recognised. This requires a change in mindset
- The following practices related to impairment are not acceptable under IFRS 9
  - Recognising a provision for losses based on a set percentage of receivable balances unless if the resulting estimates are consistent with the impairment requirements under IFRS 9
  - Suspending interest accruals
  - Recognising an impairment loss in excess of the impairment requirement of IFRS 9, even if local regulations require a specific amount to be set aside
  - If an entity wishes to identify reserves in addition to the loss allowance calculated under IFRS, it may do so by transferring amounts from retained earnings to a separate category of equity.

Impairment

- IFRS 9 does not define the term 'default' but requires each entity to do so. The definition has to be consistent with that used for internal credit risk management purposes for the relevant financial instrument;
- The term 'significant increase in credit risk' is also not defined. An entity assesses at each reporting date whether the credit risk on a instrument has increased significantly since initial recognition;
- This is by considering changes in the risk of default instead of changes in the amount expected;
- Obtaining information that is forward looking to determine if there has been a significant increase in credit risk so that the entity does not rely solely on past –due data;

Impairment

- Determining cash shortfalls – a cash shortfall is the difference between the cash flows due to the entity in accordance with the contract and the cash flows that the entity expects to receive.
- Because the estimation of credit losses considers the amount and the timing of payments, a cash shortfall arises even if the entity expects to be paid in full but a later than the date on which payment is contractually due. This delay gives rise to an expected credit loss, except if you expect to receive additional interest in respect of the late payment.
- The estimate of expected credit losses reflects an unbiased and probability weighted amount, determined by evaluating a range of possible outcomes rather than based on a bet – or worst case scenario.
- Time value of money – determine the appropriate discount rate e.g. Effective rate of interest

Impairment

- Information to be used – the estimates of expected credit losses are required to reflect reasonable and supportable information that is available without undue cost or effort. Potential sources of information include internal historical credit loss experience, internal and external ratings, credit losses of other entities etc
- Historical information is an important base from which to measure expected credit losses. It is adjusted on the basis of current observable data that reflect current conditions and an entity's forecast of future conditions during the life of the instrument.
- Collateral – estimating the amount and timing of the cash flows