FINANCIAL REPORTING WORKSHOP

IFRS 9: FINANCIAL INSTRUMENTS

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Agenda

- Why the transition to IFRS 9?
- Classification and Significant Accounting policies – a comparative analysis for IAS39 and IFRS9
- Measurement and recognition
- Effective date, transitional provisions and disclosures
- Impairment and Impairment models
- Effect on the Kenya financial sector (implications on access to credit)

Overview of IFRS 9

- IFRS 9 Financial Instruments is the IASB's replacement of IAS 39 Financial Instruments: Recognition and Measurement.
- The Standard includes requirements for recognition and measurement, impairment, derecognition and general hedge accounting.
- The version of IFRS 9 was issued in 2014 and supersedes all previous versions and is mandatorily effective for periods beginning on or after 1 January 2018 with early adoption permitted.

Transition to IFRS 9

IFRS 9 contains significant changes from IAS 39 with regards to the classification, measurement, impairment and hedge accounting requirements for financial instruments.

Following the financial crisis in 2008, IAS 39 came under heavy scrutiny, with many stakeholders opining that it could have contributed to the crisis.

There was therefore the need for improvement of the standard for financial instruments with the view to increase financial stability, taking into account:

- the complexity of the existing standard for financial instruments,
- the extent to which the financial instruments are subject to fair value,
- the procedure of recognition and measurement of financial instruments.

Focus of IFRS 9
Classification and Measurement

- Classification determines how financial assets and financial liabilities are accounted for in financial statements and, in particular, how they are measured on an ongoing basis.
- IFRS 9 introduces a logical approach for the classification of financial assets driven by **cash flow characteristics** and the **business model** in which an asset is held.
- This single, principle-based approach replaces existing rule-based requirements that are complex and difficult to apply.
- The new model also results in a single impairment model being applied to all financial instruments removing a source of complexity associated with previous accounting requirements.

Focus of IFRS 9
Classification and Measurement

Initial measurement of financial instruments

- Under IFRS 9 all financial instruments are initially measured at fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs. This requirement is consistent with IAS 39.

Financial assets: subsequent measurement

- Consistent with IAS 39, the classification of a financial asset is determined at initial recognition, however, if certain conditions are met, an asset may subsequently need to be reclassified.

Focus of IFRS 9
Classification and Measurement

Subsequent measurement

Subsequent to initial recognition, all assets within the scope of IFRS 9 are measured at:

- ✓ amortised cost;
- ✓ fair value through other comprehensive income (FVTOCI); or
- ✓ fair value through profit or loss (FVTPL).

The FVTOCI classification is mandatory for certain debt instrument assets unless the option to FVTPL ('the fair value option') is taken.

For equity investments, the FVTOCI classification is an election

Focus of IFRS 9
Classification and Measurement

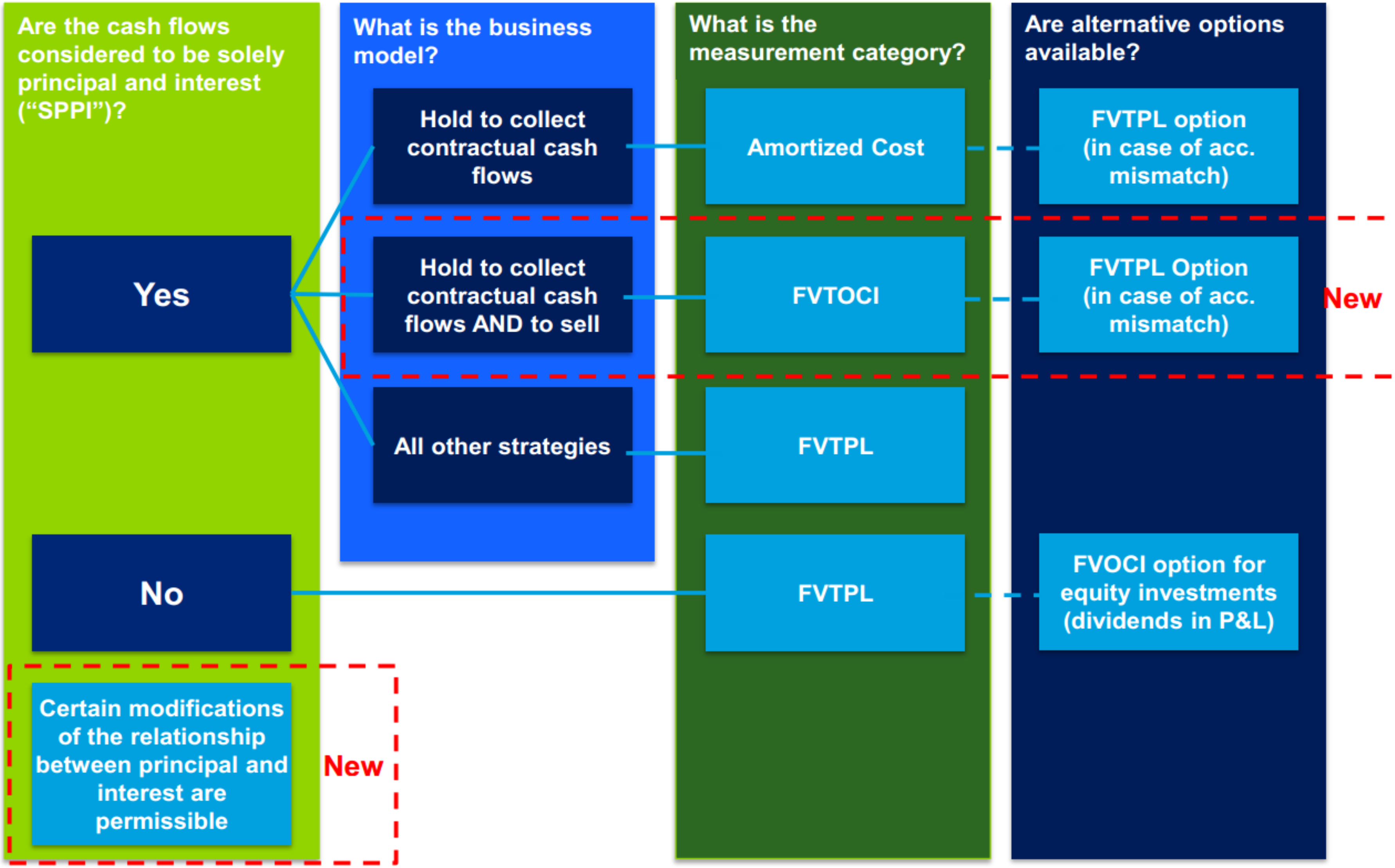
Debt Instruments

A debt instrument that meets the following two conditions must be measured at amortised cost unless the asset is designated at FVTPL under the fair value option:

- **Business model test:** The financial asset is held within a business model whose objective is to hold financial assets to collect their contractual cash flows (rather than to sell the assets prior to their contractual maturity to realise changes in fair value).
- **Cash flow characteristics test:** The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal amount outstanding

Classification and Measurement—overview

Financial assets



Source: Afrinsight

Focus of IFRS 9 Impairment

- During the financial crisis, the delayed recognition of credit losses on loans (and other financial instruments) was identified as a weakness in existing accounting standards.
- IFRS 9 has introduced a new, expected loss impairment model that will require more timely recognition of expected credit losses.
- Specifically, the new Standard requires entities to account for expected credit losses from when financial instruments are first recognized and it lowers the threshold for recognition of full lifetime expected losses.

Expected credit losses

Credit losses

The difference between:

1) All contractual cash flows that are due to an entity in accordance with the contract; and
2) All the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original **effective interest rate.**

(NB, for purchased or originated credit-impaired financial assets, apply the credit adjusted effective interest rate).

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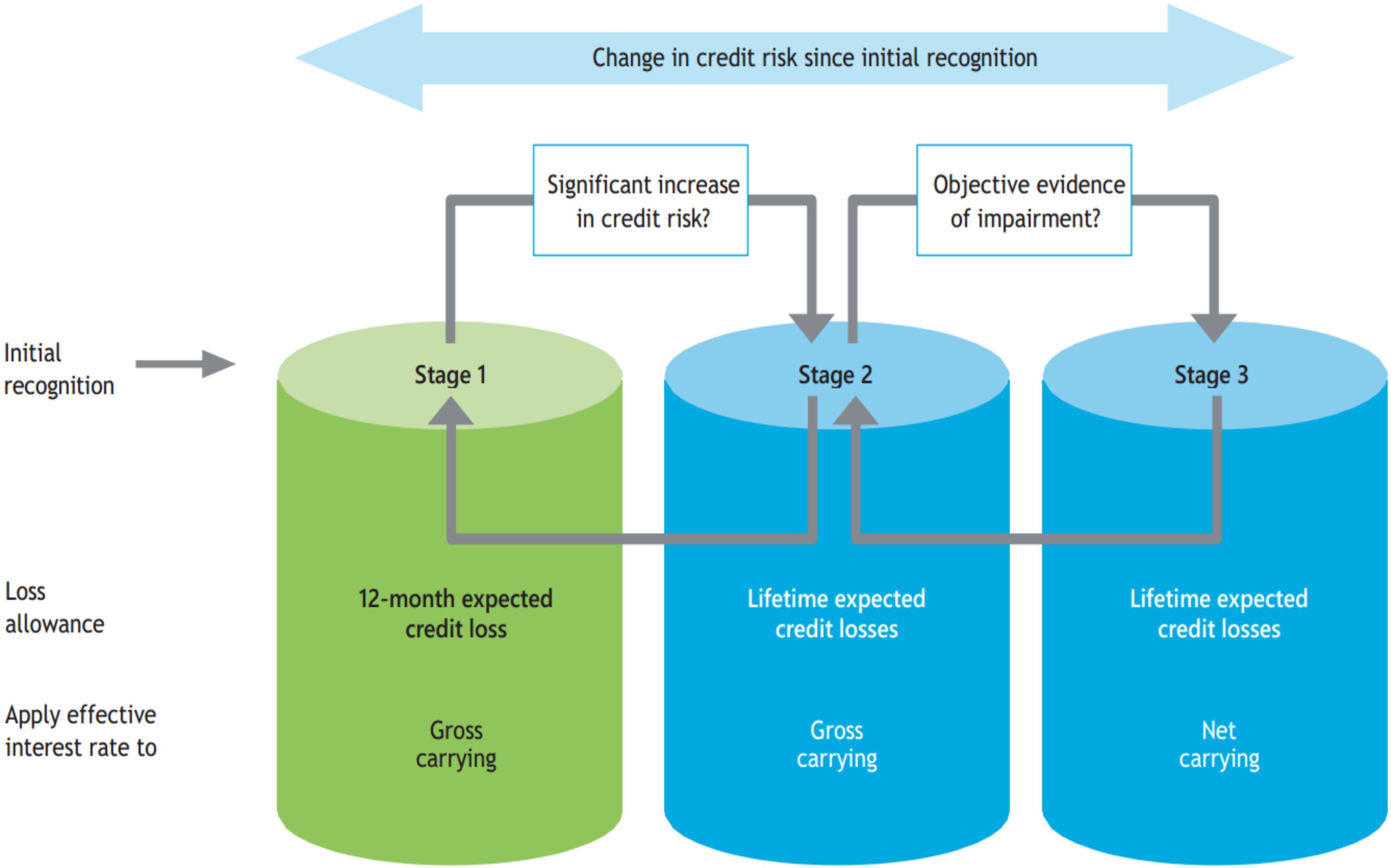
Expected credit losses

The weighted average of **credit losses** with the respective risks of a default occurring as the weights.

Source: Afrinsight

The IFRS 9 general impairment model is summarised below.



Source: Deloitte

Focus of IFRS 9
Hedge Accounting

- IFRS 9 introduces a substantially-reformed model for hedge accounting with enhanced disclosures about risk management activity.
- The new model represents a substantial overhaul of hedge accounting that aligns the accounting treatment with risk management activities, enabling entities to better reflect these activities in their financial statements.
- In addition, as a result of these changes, users of the financial statements will be provided with better information about risk management and the effect of hedge accounting on the financial statements.

Focus of IFRS 9
Hedge Accounting

- The application of the hedge accounting requirements in IFRS 9 is optional.
- If certain eligibility and qualification criteria are met, hedge accounting can allow an entity to reflect its risk management activities in the financial statements by matching gains or losses on hedging instruments (e.g. derivatives) with losses or gains on the risk exposures they hedge (e.g. foreign currency sales)

Hedge Accounting
Qualifying criteria for hedge accounting

A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

- the hedging relationship consists only of eligible hedging instruments and eligible hedged items;
- at inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge; and
- the hedging relationship meets all of the hedge effectiveness requirements

Effective date, transitional provisions and disclosures

- IFRS 9 is effective for annual periods beginning on or after 1 January 2018 and, subject to local endorsement requirements, is available for early adoption.
- An entity with a date of initial application before 1 February 2015 can apply earlier versions of IFRS 9 in the annual periods that begin prior to 1 January 2018, subject to local endorsement requirements.
- IFRS 9 should be applied retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting, Estimates and Errors.

Disclosures (amendments to IFRS 7)

Classification and measurement

- Disclosures include a requirement to analyze gains and losses resulting from the derecognition of financial assets measured at amortised cost.
- The purpose of these disclosures is to highlight the degree to which, and reasons why, amortised cost assets are derecognized before maturity, in light of the business model objective for those assets being held to collect.
- IAS 1 is also amended to require a line item in the income statement for gains and losses arising from the derecognition of financial assets measured at amortised cost

Disclosures (amendments to IFRS 7)

Credit Risk Disclosures

- The credit risk disclosures require information about credit risk management practices and credit risk exposures.
- In addition, extensive qualitative and quantitative information about amounts arising from, and changes in, expected credit losses is required. This includes detailed reconciliations of the loss allowance by class.
- The disclosures are designed to allow users to understand the application and effect of the IFRS 9 impairment model, including information about the judgements made when applying the model.

Disclosures (amendments to IFRS 7)

Hedge Accounting Disclosures

- The hedge accounting disclosures are also extensive and also apply to those entities that, upon adopting IFRS 9, elect to continue to apply the hedge accounting requirements of IAS 39.
- The disclosures require information about an entity's risk management strategy and its effect on future cash flows.
- Detailed disclosures about the effect hedge accounting has had on the primary financial statements is also required

Effect of IFRS 9 on Kenyan financial sector

- Early recognition of impairment loss, most likely at the origination of a credit facility.
- Likely negative impact of capital requirements of ‘small’ banks.
- Comprehensive data to be collected on customers, market conditions to substantiate business model and risk assessment.
- High level scrutiny in profiling customers with increased focus on cross referencing.
- Increased default rates likely to lower credit rating of customers across institutions.
- Proactive debt collection
- Shift to short term loans

Interactive Session

ICPAK
Uphold Public Interest