

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.
- ❑ 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

Financial Assets

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, as follows:

Amortised cost—a financial asset is measured at amortised cost if **both** of the following conditions are met:

- the asset is held within a business model whose objective is to **hold assets in order to collect contractual cash flows rather than with a view to selling the asset to realize a profit or loss** ; and
- 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**

Focus of IFRS 9

Examples - Amortized cost



Examples of financial instruments that are likely to be classified and accounted for at amortised cost under IFRS 9 include:

- Trade receivables
- Loan receivables with 'basic' features
- Investments in government bonds that are not held for trading
- Investments in term deposits at standard interest rates.

Classification and Measurement - FVTOCI



- Financial assets are classified and measured at fair value through other comprehensive income if they are held in a business model whose objective is achieved by **both collecting contractual cash flows and selling financial assets**.
- This business model typically involves **greater frequency and volume of sales** than the 'hold-to-collect' business model.
- Integral to this business model is an **intention to sell** the instrument **before** the investment matures.
- Examples of financial instruments that may be accounted for at FVTOCI include *Investments in government bonds or corporate bonds where the investment period is likely to be shorter than maturity*.

Classification and Measurement

– FVTOCI (Equity)



- IFRS 9 requires **all equity investments to be measured at fair value**. The default approach is for all changes in fair value to be recognised in **profit or loss**.
- However, for equity investments that are not held for trading, entities can make an **irrevocable election at initial recognition** to classify the instruments as at **FVOCI**, with all subsequent changes in fair value being recognised in **OCI**.
- This election is available for **each separate investment**.
- Under this new FVOCI category, **fair value changes** are recognised in **OCI** while **dividends** are recognised in **profit or loss**.
- **On disposal** of the investment the cumulative change in fair value is required to **remain in OCI** and is not recycled to profit or loss.

Classification and Measurement - FVTPL



- ❑ Any financial assets that are not held in one of the two business models mentioned are measured at fair value through profit or loss.
- ❑ A financial asset is classified and measured at FVTPL if the financial asset is:
 - A held-for-trading financial asset
 - A debt instrument that does not qualify to be measured at amortised cost or FVOCI
 - An equity investment which the entity has not elected to classify as at FVOCI
 - A financial asset where the entity has elected to measure the asset at FVTPL under the fair value option (FVO)

When, and only when, an entity changes its business model for managing financial assets it must reclassify all affected financial assets.

Classification and Measurement - FVTPL

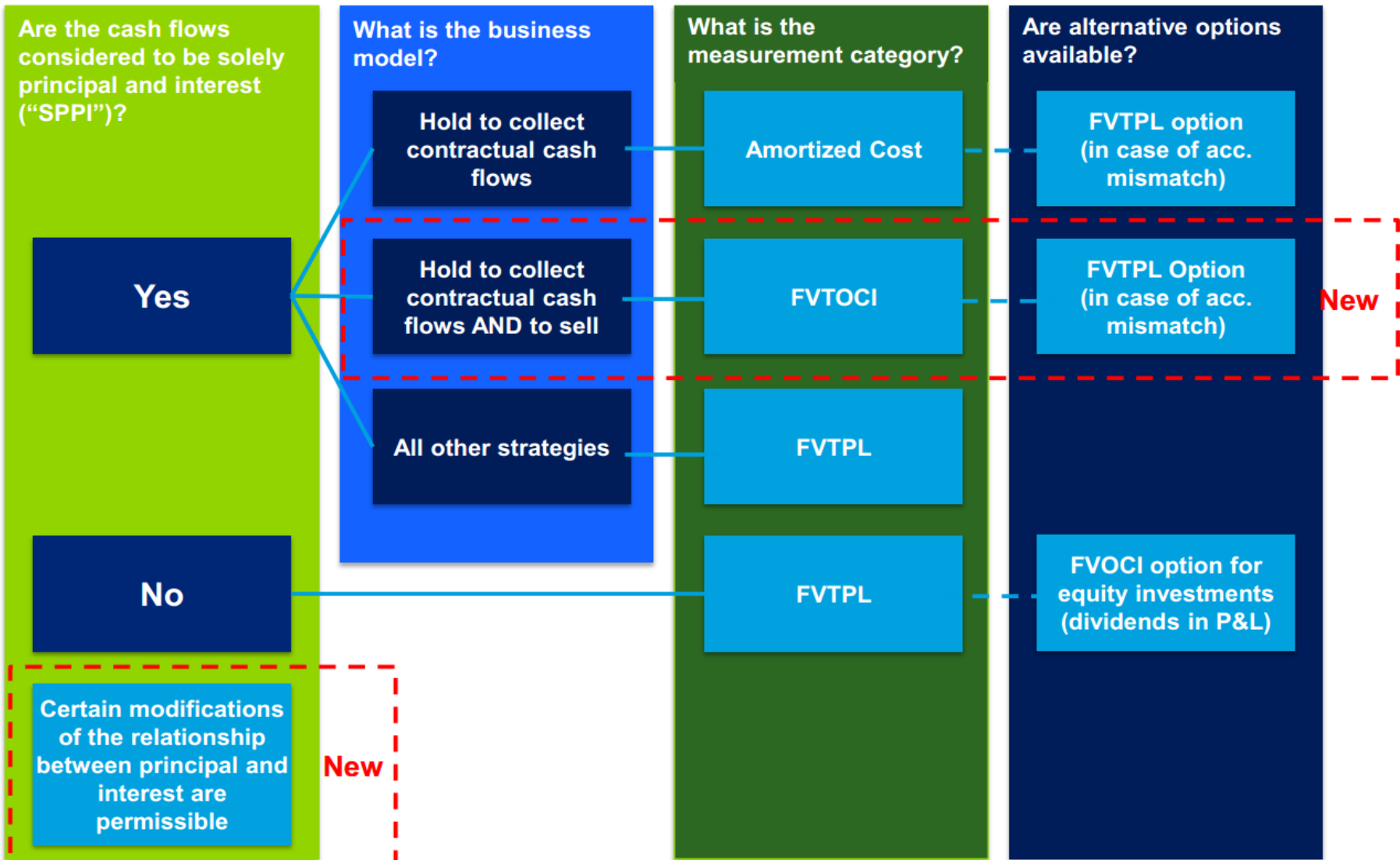


Examples of financial instruments likely to fall under the FVTPL category include:

- Investments in shares of listed companies that the entity has **not elected to account for as at FVOCI**
- Derivatives that have **not** been designated in a hedging relationship, e.g.:
 - **Interest rate swaps**
 - **Commodity futures/option contracts**
 - **Foreign exchange futures/option contracts**
- Investments in convertible notes, commodity linked bonds
- **Contingent consideration** receivable from the sale of a business

Classification and Measurement—overview

Financial assets



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 that it lowers the threshold for recognition of full lifetime expected losses.

Focus of IFRS 9

Impairment - Scope



The following financial instruments are included within the scope of the impairment requirements in IFRS 9 Financial Instruments:

- ☐ Debt instruments measured at amortised cost, e.g.
 - Trade receivables,
 - Loans receivable from related parties or key management personnel,
 - Deferred consideration receivable, and
 - Intercompany loans in separate financial statements.
- ☐ Debt instruments that are measured at FVOCI
- ☐ Loan commitments (except those measured at FVTPL)
- ☐ Financial guarantee contracts (except those measured at FVTPL)
- ☐ Lease receivables within the scope of IAS 17 Leases
- ☐ Contract assets within the scope of IFRS 15 Revenue from Contracts with Customers

Focus of IFRS 9

Impairment



Impairment of financial assets is recognised in stages:

Stage 1

- As soon as a financial instrument is originated or purchased, **12-month expected credit losses** are recognised in **profit or loss** and a **loss allowance** is established.
- For financial assets, **interest revenue** is calculated on the **gross carrying amount** (i.e., without deduction for expected credit losses).

Stage 2

- If the credit risk increases significantly and is not considered low, **full lifetime expected credit losses** are recognised in **profit or loss**.
- The calculation of interest revenue is the **same as for Stage 1**.

Focus of IFRS 9

Impairment



Impairment of financial assets is recognised in stages:

Stage 3

- If the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the **amortised cost**.
- Financial assets in this stage will generally be assessed **individually**.
- **Lifetime expected credit losses** are recognised on these financial assets.

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**.

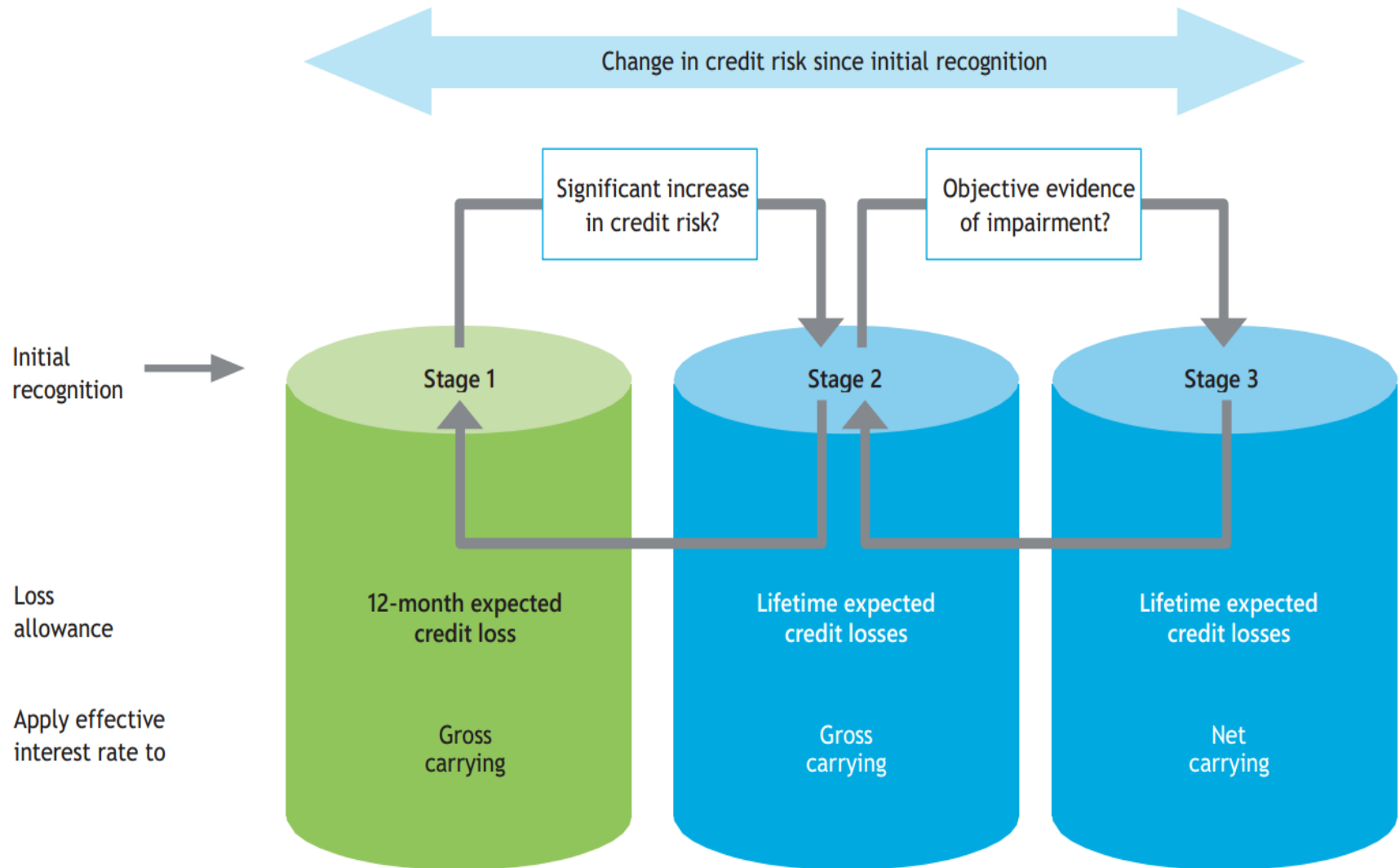
(NB, for purchased or originated credit-impaired financial assets, apply the credit adjusted effective interest rate).



Expected credit losses

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

The IFRS 9 general impairment model is summarised below.



Source: Deloitte

General Impairment model



A **significant increase in credit risk** (moving from **Stage 1** to **Stage 2**) can include:

- Changes in general **economic and/or market conditions** (e.g. expected increase in unemployment rates, interest rates)
- Significant changes in the **operating results** or **financial position** of the borrower
- Changes in the amount of **financial support** available to an entity (e.g. from its parent)
- Expected or potential **breaches** of covenants
- Expected **delay** in payment (Note: Actual payment delay may not arise until after there has been a significant increase in credit risk).

Credit-impaired model



- ❑ Credit-impaired financial assets are those for which **one or more events that have a detrimental effect on the estimated future cash flows have already occurred.**
- ❑ These financial assets would be in **Stage 3** and **lifetime expected losses** would be recognised.
- ❑ Indicators that an asset is credit-impaired would include observable data about the following events:
 - **Actual breach of contract** (e.g. default or delinquency in payments)
 - **Granting of a concession** to the borrower due to the borrower's financial difficulty
 - Probable that the borrower will enter **bankruptcy** or other financial **reorganisation**

Simplified Impairment model



- ❑ For trade receivables and contract assets that **do not contain a significant financing component** in accordance with IFRS 15, 'lifetime expected credit losses' are recognised.
- ❑ Because the maturities will typically be 12 months or less, **the credit loss for 12-month and lifetime expected credit losses would be the same.**
- ❑ The new impairment model allows entities to calculate expected credit losses on trade receivables using a **provision matrix.**
- ❑ Under the new model, entities will need to update their **historical provision rates with current and forward looking estimates.**
- ❑ A similar approach might be followed for **contract assets.**

Focus of IFRS 9

Hedge Accounting



- The objective of hedge accounting is to represent, in the financial statements, **the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or other comprehensive income.**
- Hedge accounting is **optional**.
- An entity applying hedge accounting designates a **hedging relationship** between a hedging instrument and a hedged item.
- For hedging relationships that meet the **qualifying criteria** in IFRS 9, an entity accounts for the **gain or loss** on the hedging instrument and the hedged item in accordance with the special hedge accounting provisions of IFRS 9

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

Financial Liabilities



- All financial liabilities are measured at **amortised cost**, except for financial liabilities at fair value through profit or loss.
- Such liabilities include **derivatives** (other than derivatives that are financial guarantee contracts or are designated and effective hedging instruments), other **liabilities held for trading**, and liabilities that an entity designates to be measured at fair value through profit or loss.

*After initial recognition, an entity **cannot** reclassify any financial liability.*

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

