



# Applying IFRS 9 –Part II (Discussion)

Presentation by:

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# IFRS 9

- Discussion and illustrations on the key changes?



# Presentation agenda



- Introduction
- Classification and measurement
- Impairment
- Q&A

# Introduction – summary of changes



## IFRS 9 will affect...

|                              |                                                                                                                                                                                         |
|------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Credit losses                | Reported credit losses are expected to increase and become more volatile under the new expected credit loss model. The number and complexity of judgments is also expected to increase. |
| Classification & measurement | How financial assets are classified becomes more judgmental and may affect how capital resources and requirements are calculated.                                                       |
| Disclosures                  | Extensive new disclosures are required – system and controls changes will be necessary to capture the required data.                                                                    |

# Classification and measurement



- Similar categories:

| IFRS 9         | IAS 39                     |
|----------------|----------------------------|
| FVTPL          | FVTPL                      |
| Amortised cost | Loans and receivables/HTM* |
| FVOCI          | AFS*                       |

\*Significant changes in criteria for classifying assets.

FVTPL – Fair value through profit or loss

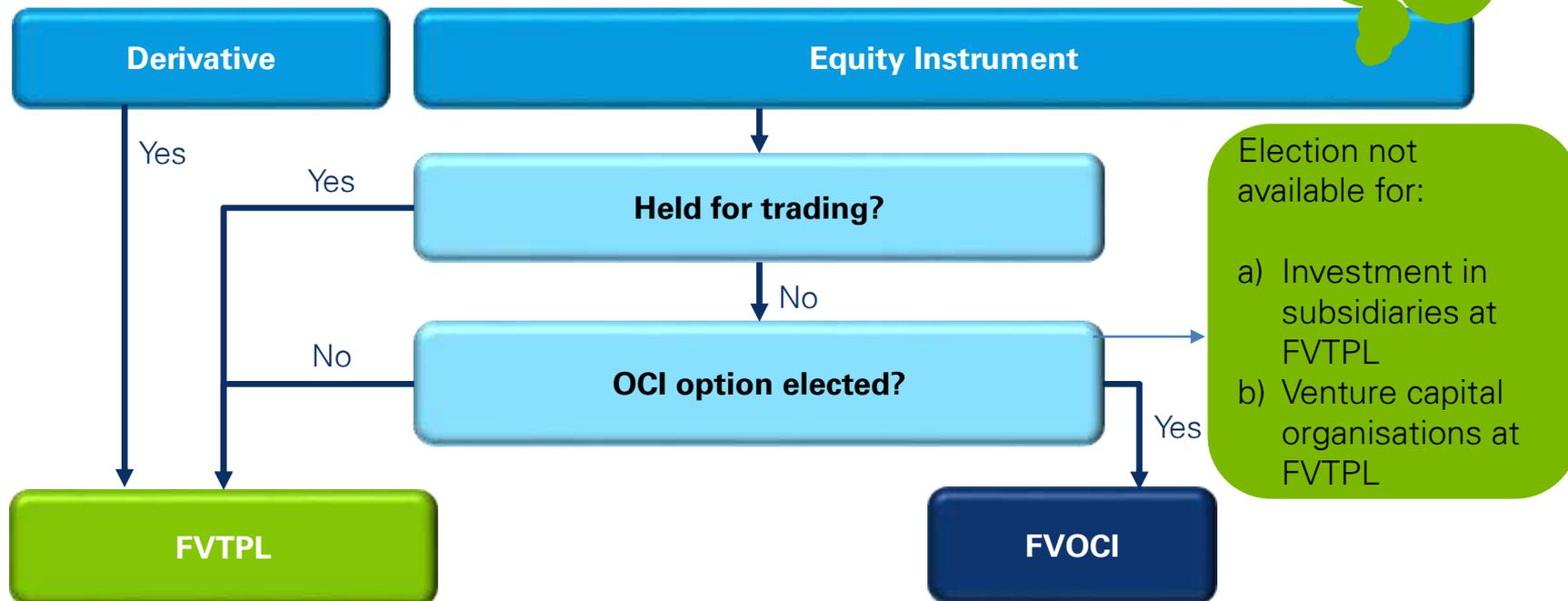
FVOCI – Fair value through other comprehensive income

HTM – Held to maturity

AFS – Available for sale

# IFRS 9 – Equity and derivative financial asset classification

No separation of embedded derivatives

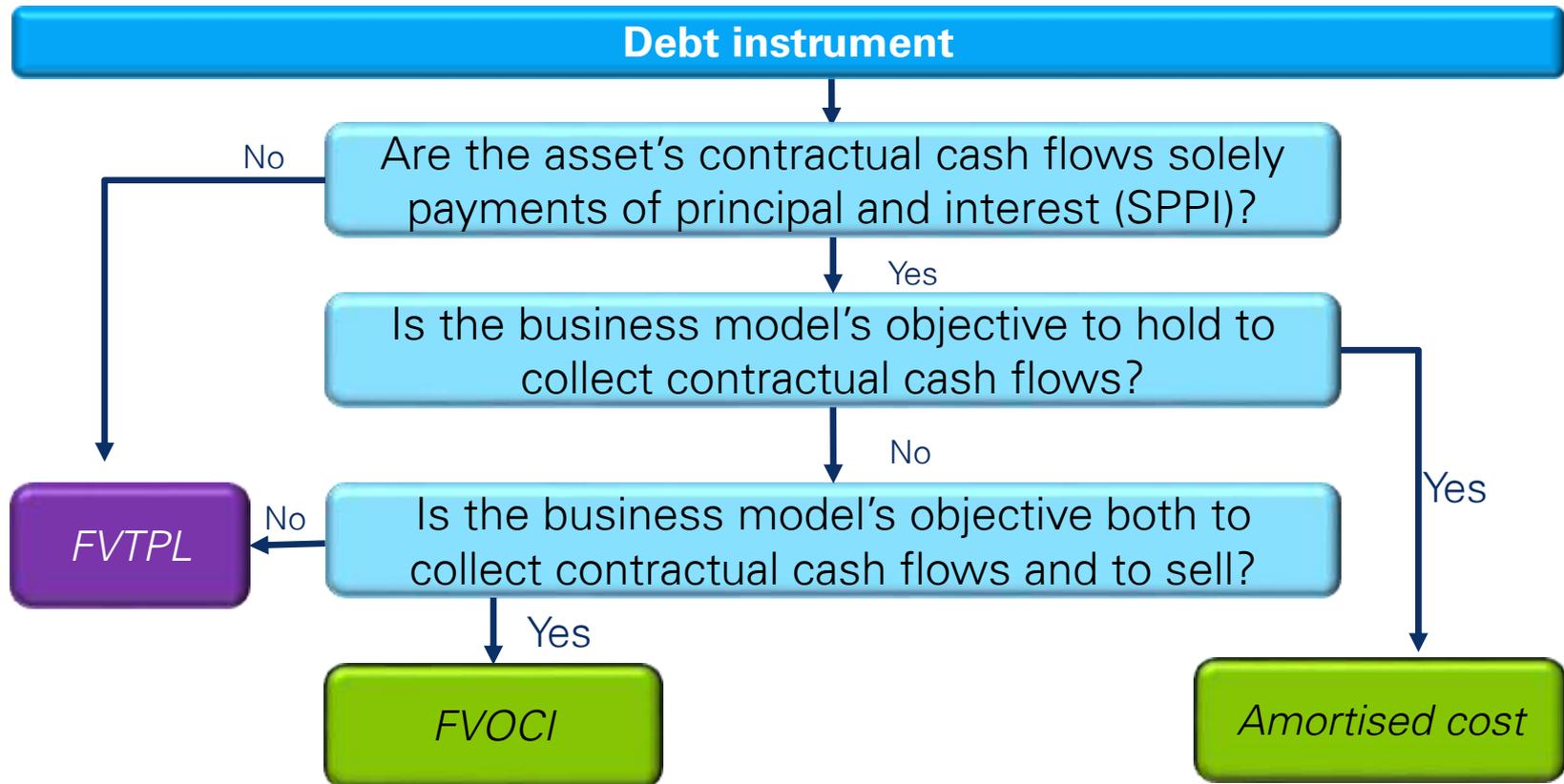


Election not available for:

- a) Investment in subsidiaries at FVTPL
- b) Venture capital organisations at FVTPL

- Irrevocable
- Changes in fair value presented in OCI
- Dividends generally recognised in P&L
- No reclassification of gains and losses into P&L on disposal and no impairment recognised in P&L

# IFRS 9 – Debt instruments classification



# Types of Business Models



## Held-to-collect contractual cash flows

Matter of fact

- Financial assets held to collect contractual cash flows over the life of the instrument.
- Need not hold all instruments until maturity.
- Selling assets is incidental to business model objective.

Amortised cost \*

## Held both to collect contractual cash flows and to sell

- Both collecting contractual cash flows and selling financial assets are integral to achieving objective of business model.
- Typically involves greater frequency and value of sales compared to held to collect model.

FVOCI\*

## Other business models

- Models that do not meet the above criteria.

FVTPL \*\*

Judgements

\* Subject to meeting SPPI criterion and the fair value option

\*\* SPPI criterion is irrelevant (all in this category would be measured at FVTPL)

# Question: Classification equity/liability



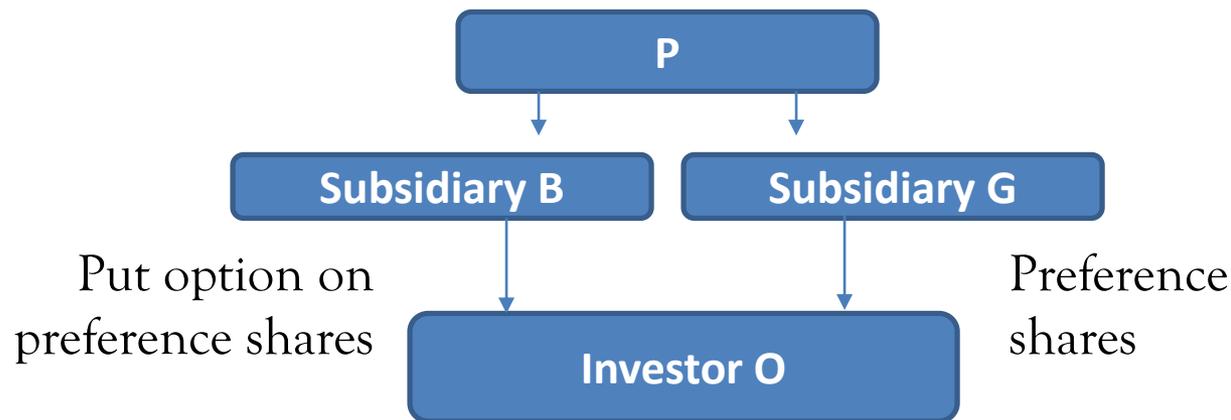
An entity K issues a non-redeemable preference shares with dividends only payable if interest is paid on another instrument (the 'linked' instrument). K is required to pay interest on the linked instrument.

Discuss classification of the non-redeemable instrument.

# Question: Classification equity/liability



Company P has two subsidiaries, Companies B and G. G issues non-redeemable preference shares to a party (investor O) outside the group. B writes a put option on the preference shares issued by G. The put option, if it is exercised, will require B to purchase the preference shares from the holder for cash.



**Determine classification of the preference shares:**

- G's financial statements
- P's consolidated financial statements

# Question: Assessing the business model (factoring)



An entity has a business model with the objective of providing credit to customers and immediately selling the debtors to a financial institution (i.e. recurring factoring of debtors).

**What is the entity's business model?**

- A. Held-to-collect contractual cash flows
- B. Held both to collect contractual cash flows and to sell
- C. Other business model
- D. It depends.

# Question: Assessing the business model (factoring)



Company D originates loans for the purpose of selling them to a securitisation vehicle, which D controls and consolidates. The loans are derecognised from D's separate statement of financial position and recognised by the securitisation vehicle. On consolidation, the loans remain within the consolidated group.

**Determine classification of the loans:**

- a) In D's separate financial statements
- b) In D's consolidated financial statements

# Question: Variable rate instrument



Company X acquires a floating rate non-pre-payable bond on the bond's issuance date at CU80. The bond has a par amount of CU100 and pays interest on the par amount based on three-month LIBOR, reset every three months. The discount of CU20 exists because investors demand a higher effective yield than the stated contractual interest rate due to credit risk and liquidity risk.

**Determine classification of the bond if:**

- a) The borrower is contractually required to pay CU100 on maturity
- b) The borrower is contractually required to pay CU80 on maturity

# Example: Long term equity investment measured at fair value



- Company X has an investment in an unlisted equity instrument that it holds as part of strategic investments for long term. It measures the investment at fair value. Assume the cost of the equity investment was KES100M. The fair value at year-end is KES130M and during the period Company X received dividends of KES10M.

|                                 | (Current)<br>IAS 39 treatment | (New)<br>IFRS 9 FVTPL                 | (New)<br>IFRS 9 FVOCI |
|---------------------------------|-------------------------------|---------------------------------------|-----------------------|
| Statement of Financial Position | Fair value KES130M            | Fair value KES130M                    | Fair value KES130M    |
| Profit or loss                  | Dividends KES10M              | Dividends KES10M<br>Fair value KES30M | Dividends KES10M      |
| OCI                             | Fair value KES30M             |                                       | Fair value KES30M     |

Reclassify to profit or loss on disposal

Never reclassified to profit or loss

# Question – transaction costs



Entity A incurred transaction costs when it purchased Financial Instrument B. Which classification categories in IFRS 9 will permit Entity A to capitalise the transaction costs.

- A. FVTPL and FVOCI
- B. Amortised Cost
- C. FVTPL
- D. Amortised cost and FVOCI.

# Question – Equity positions

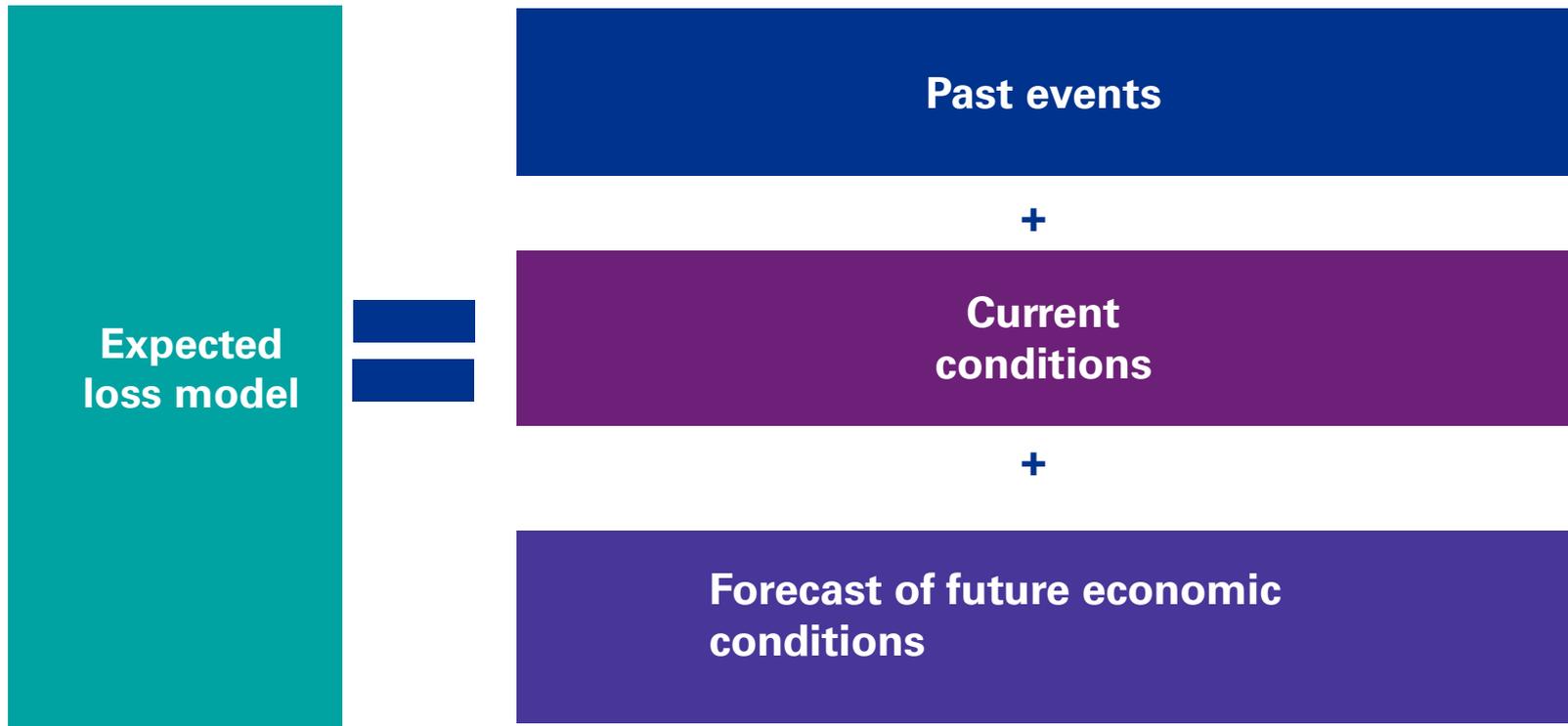


In Jan 2012 , Entity B acquired a 25% interest in Entity C and it was concluded that Entity B has significant influence. In Jan 2014, Entity B lost significant influence in Entity C and now has a 15% interest in Entity C. Subsequently in Jan 2015, Entity B gained an additional 5% and obtained significant influence in Entity C again.

In Jan 2016, Entity B lost significant influence again and now has a 10% interest in Entity B. How should this be accounted for in terms of IFRS 9 each time there is a loss of significant influence?

- A. Recurring: Each time the investment moves back into the scope of IFRS 9, it is seen as a new investment with a new initial recognition date.
- B. Once-Off: the initial recognition date is only the first time the investment is recognised for IFRS 9

# Impairment – the new model



# Question: 12 month vs lifetime ECL



- Company Co gives a loan of CU100 on credit to Mr. A.
- The term is 24 months, repayable in two payments of CU50 each, at the end of year 1 and year 2 respectively. Ignore interest.
- Entity A knows there is a high correlation between the risk of default & the national employment rate index.
- Entity A estimates that the risk that Mr A may lose his job in year 1 is 10% and in year 2 is 30%. If Mr A loses his job in year 1, Entity A estimates it will lose CU 100. If he loses his job in year 2, Entity A estimates to lose CU 40.

*What is the 12-month ECL at inception of the loan (ignore discounting)?*

# Question: 12 month vs lifetime ECL



What is the 12-month ECL at inception of the loan (ignore discounting)?

- A. CU 10 ( $100 \times 10\%$ ).
- B. CU 30 ( $100 \times 30\%$ )
- C. CU 4 ( $40 \times 10\%$ )
- D. CU 12 ( $40 \times 30\%$ )
- E. CU 22 ( $100 \times 10\% + 40 \times 30\%$ )



# Provision matrix

# Provisioning Matrix for Calculating Lifetime ECL's



- Manufacturer M operates only in one geographical location, and has a portfolio of trade receivables of CU30million on 31 December 20X1.
- The customer base consists of a large number of small clients.
- The trade receivables have common risk characteristics.
- The trade receivables do not have a significant financing component.
- M uses a provision matrix to calculate impairment.

## Provision matrix estimate:

|              | Current | 1–30 days past due | 31–60 days past due | 61–90 days past due | More than 90 days past due |
|--------------|---------|--------------------|---------------------|---------------------|----------------------------|
| Default rate | 0.3%    | 1.6%               | 3.6%                | 6.6%                | 10.6%                      |

The provision matrix is based on:

- historical default rates over the expected life of the trade receivables; and
- adjustment for forward-looking estimates.

# Constructing default rates (1/3)



**Historical loss-rate**

**Adjust future expectations**

**Management judgement overlay**

# Constructing default rates (2/3)



Take a snapshot at point of time (e.g. 1 January). In the example this is CU 5million. Take a second snapshot after 90 days. Compare how much of the balance moved into more than 90 days past due.

| Gross carrying amount                                                         | Current   | 1-30 days past due | 31-60 days past due | 61-90 days past due | More than 90 days past due |
|-------------------------------------------------------------------------------|-----------|--------------------|---------------------|---------------------|----------------------------|
| Current (1 <sup>st</sup> snapshot)                                            | CU 15m    | CU 7.5m            | CU 4m               | CU 2.5m             | CU 1m                      |
| 2 <sup>nd</sup> snapshot (How much of the balance moved to more than 90 dpd)  | CU 45 000 | CU 120 000         | CU 144 000          | CU 165 000          | CU 106 000                 |
| Construct default rate: (2 <sup>nd</sup> snapshot / 1 <sup>st</sup> snapshot) | 0.3%      | 1.6%               | 3.6%                | 6.6%                | 10.6%                      |

# Constructing default rates (3/3)



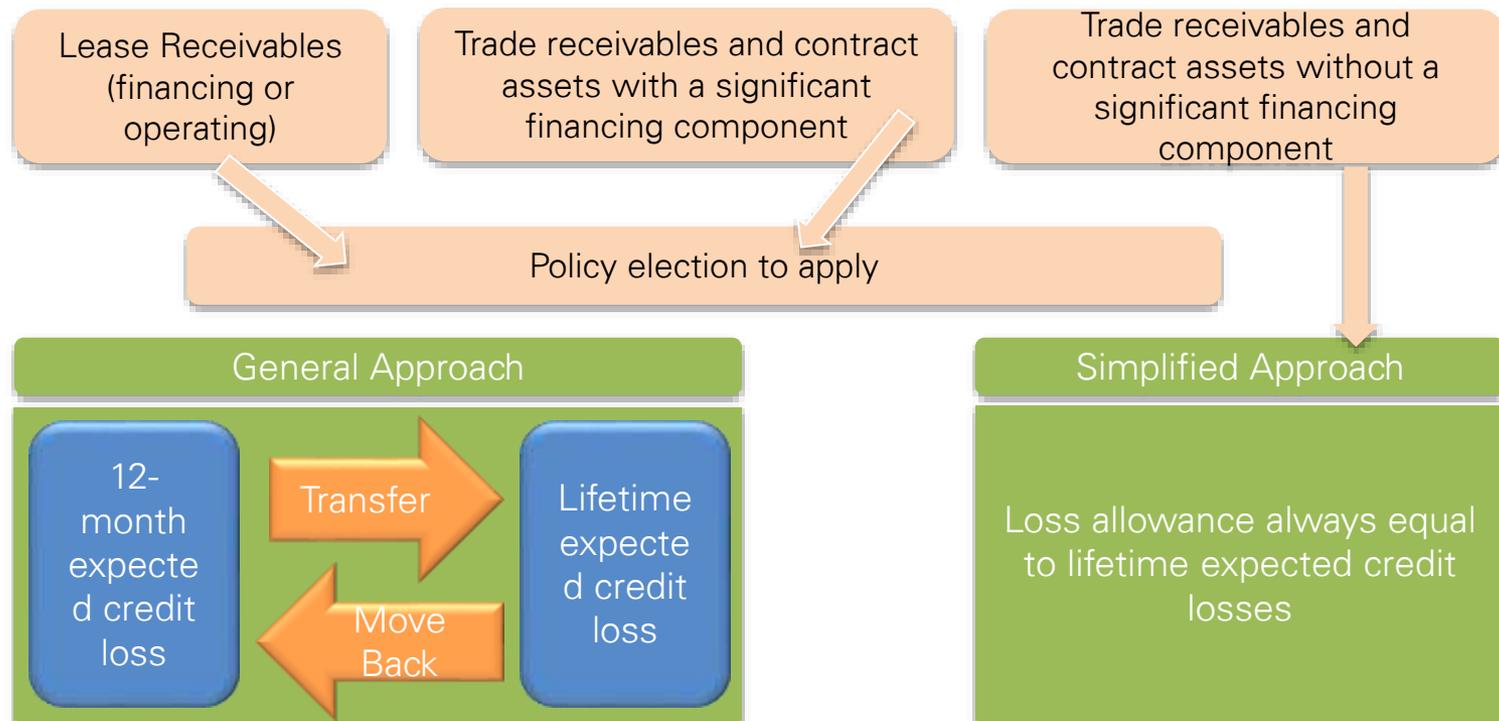
Due to Company M's nature of receivables (a large number of small clients, categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due and trade receivables do not have a significant financing component), the loss allowance for such trade receivables is always measured at an amount equal to lifetime ECL.

Company M uses a provision matrix to calculate ECL using the following provision matrix:

|                       | Current  | 1-30 days past due | 31-60 days past due | 61-90 days past due | More than 90 days past due |
|-----------------------|----------|--------------------|---------------------|---------------------|----------------------------|
| Default rate          | 0.3%     | 1.6%               | 3.6%                | 6.6%                | 10.6%                      |
| Gross carrying amount | CU 15m   | CU 7.5m            | CU 4m               | CU 2.5m             | CU 1m                      |
| Lifetime ECL          | CU45,000 | CU120,000          | CU144,000           | CU165,000           | CU106,000                  |

The lifetime ECL for the large number of small customers is accordingly the total of **CU580,000**

# Impairment – General approach versus Simplified approach



# Impairment – Simplified approach



## Example of a provision matrix

Company T has a portfolio of trade receivables of KES 30 000 at the reporting date. None of the receivables includes a significant financing component.

Company T only operates in one geographic region and has a large number of small clients.

Company T uses a provision matrix to determine the lifetime expected credit losses for the portfolio. It is based on Company T's observed default rates, and is adjusted by a forward-looking estimate that includes the probability of worsening economic environment within the next year.

At each reporting date, Company T updates the observed default history and forward-looking estimates.



# Impairment - Provision matrix (cont.)



On this basis Company T uses the following provision matrix:

|                       | Expected credit loss | Trade receivables (KES) | Impairment allowance (KES) |
|-----------------------|----------------------|-------------------------|----------------------------|
| Current               | 3.4%                 | 15 000                  | 510                        |
| 1-30 days past due    | 4.7%                 | 7 500                   | 353                        |
| 31-60 days past due   | 6.7%                 | 4 000                   | 268                        |
| 61-90 days past due   | 9.7%                 | 2 500                   | 243                        |
| Over 90 days past due | 13.5%                | 1 000                   | 135                        |
| Total                 |                      | 30 000                  | 1 509                      |

How do you calculate this percentage?

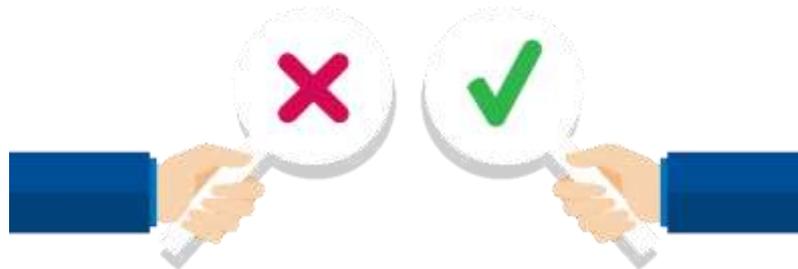
# Provision matrix



## Calculating the probability-weighted expected credit loss

This involves defining your probability parameters of when an expected loss will occur.

$$\text{Probability} = \text{event} / \text{number of outcomes}$$



For example, the event could be defined as non-payment of an invoice within the stipulated credit terms and the number of outcomes is therefore 2, being the debtor either paid or did not pay the invoice within the stipulated credit terms.

# Provision matrix (cont.)



## Example continued: Probability weighted expected credit loss

Company T sells goods on credit with invoices payable within 30 days of invoice date. Based on historic data, all invoices were either paid in full or not paid (i.e. there were no partial payments of invoices). Company T has defined the event in the probability calculation as non-payment of an invoice within 30 day credit term. Historic data showed the following trend in invoice payments:

|                                                                              |              |
|------------------------------------------------------------------------------|--------------|
| Number of invoices paid within 30 days                                       | 1 400        |
| Number of invoices paid after 30 days or still outstanding at reporting date | 50           |
| <b>Total number of invoices</b>                                              | <b>1 450</b> |

Based on the above table, the probability that a debtor will not pay their invoice within the 30 day credit term is 3.4% (50/1450). This is the base expected credit loss to be applied to all the buckets.

# Q&A

