Putting IFRS 9 into practice

Presentation by:

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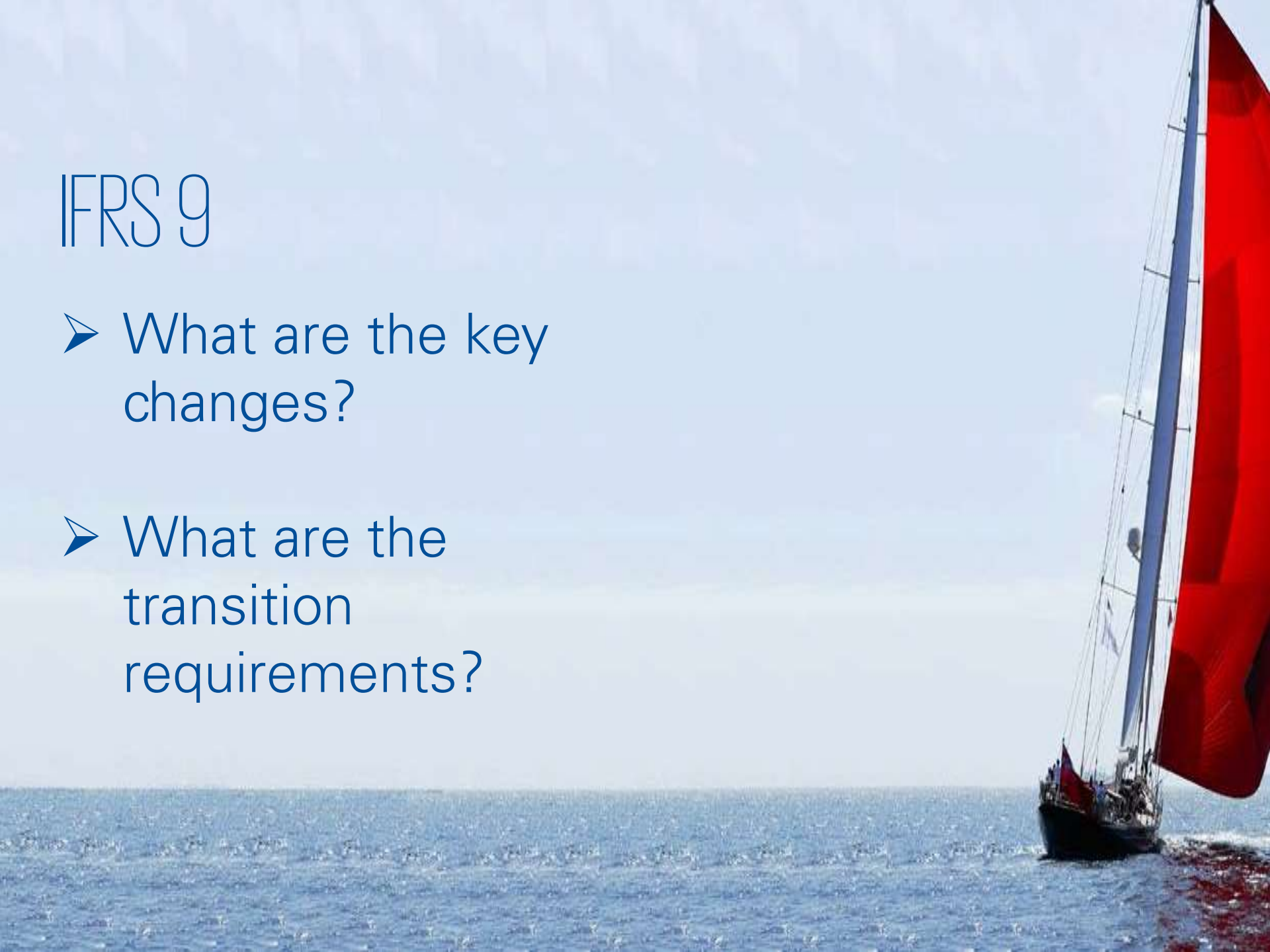
Uphold public interest

IFRS 9

- What are the key changes?
- What are the transition requirements?



Presentation agenda

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

Introduction – summary of changes

IFRS 9 will affect...	
Credit losses	Reported credit losses to be determined using the expected credit loss model from the current incurred credit loss model.
Classification & measurement	Classification is now more judgmental and is driven by the entity's business model.
Disclosures	Extensive new disclosures are required for IFRS 7.

Classification and measurement

- Similar categories:

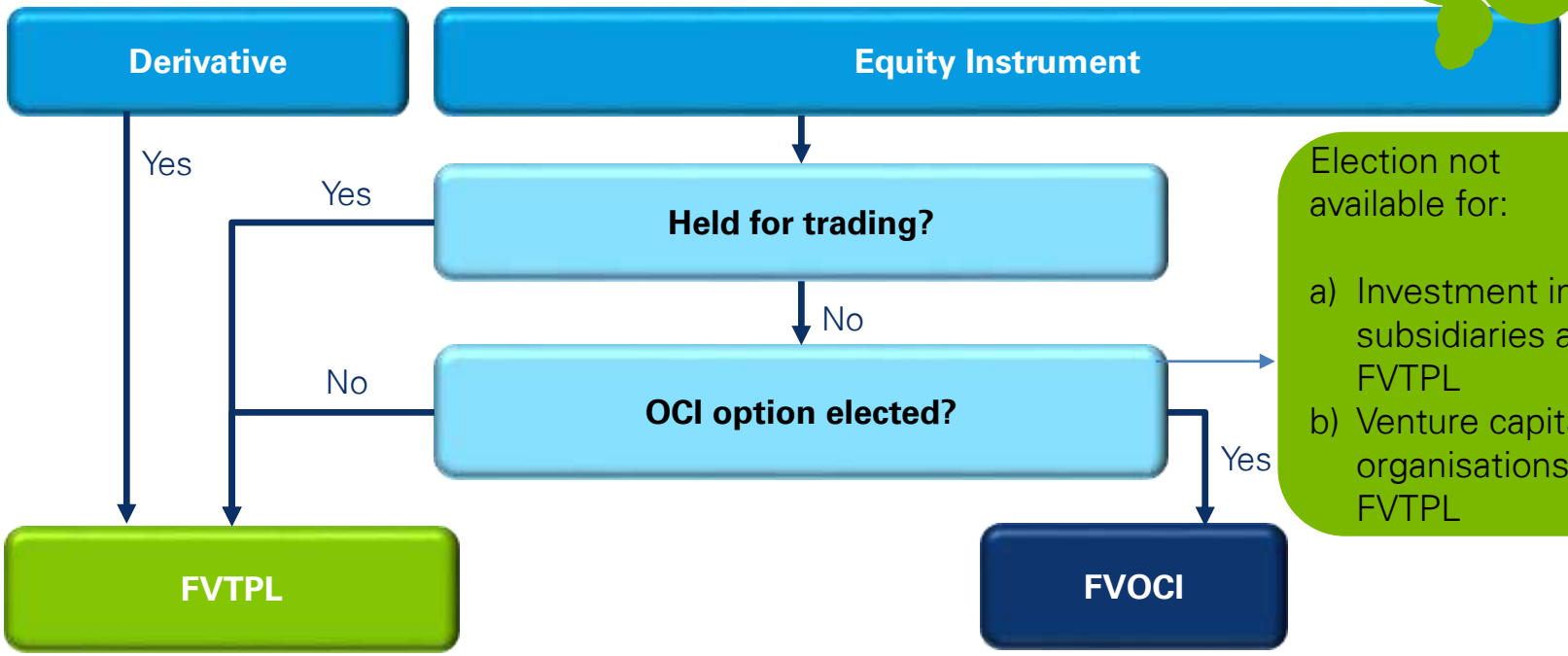
IFRS 9	IAS 39
FVTPL	FVTPL
Amortised cost	Loans and receivables/HTM*
FVOCI	AFS*

*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

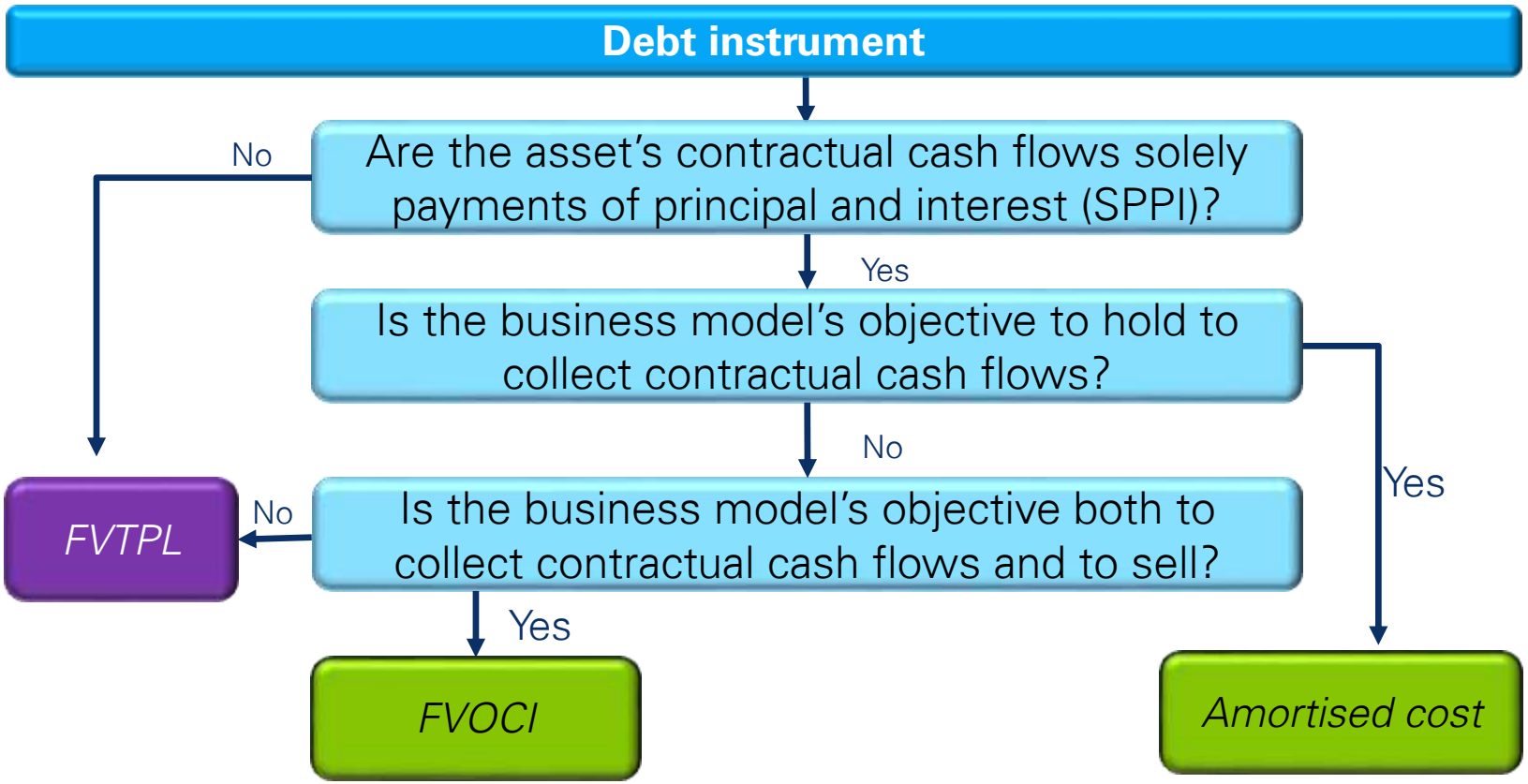


Election not available for:

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.

Amortised cost *

— Selling assets is incidental to business model objective.

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)

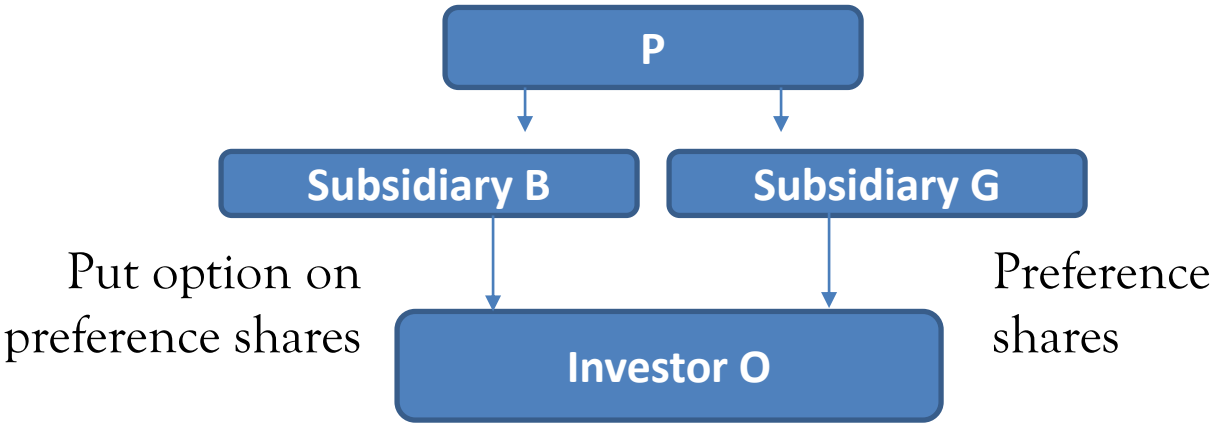
Question: Classification equity/liability

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:

a) G's financial statements
b) 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

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) IAS 39 treatment	(New) IFRS 9 FVTPL	(New) IFRS 9 FVOCI
Statement of Financial Position	Fair value KES130M	Fair value KES130M	Fair value KES130M
Profit or loss	Dividends KES10M	Dividends KES10M 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

Reclassification mechanics

		TO:	
		FVTPL	**Amortised cost**
FROM:	**FVOCI**	Continue to measure at fair value. Reclassify accumulated OCI balance to P/L	Derecognised accumulated OCI, with offsetting entry against fair value carrying amount. Adjusted carrying amount = amortised cost
		FVOCI	**Amortised cost**
	FVTPL	Continue to measure at fair value. Recognise subsequent changes in fair value in OCI. Fair value on reclassification date = new gross carrying amount. Calculate EIR based on new gross carrying amount.	Fair value on reclassification date = new gross carrying amount. Calculate EIR based on new gross carrying amount.

Reclassification mechanics

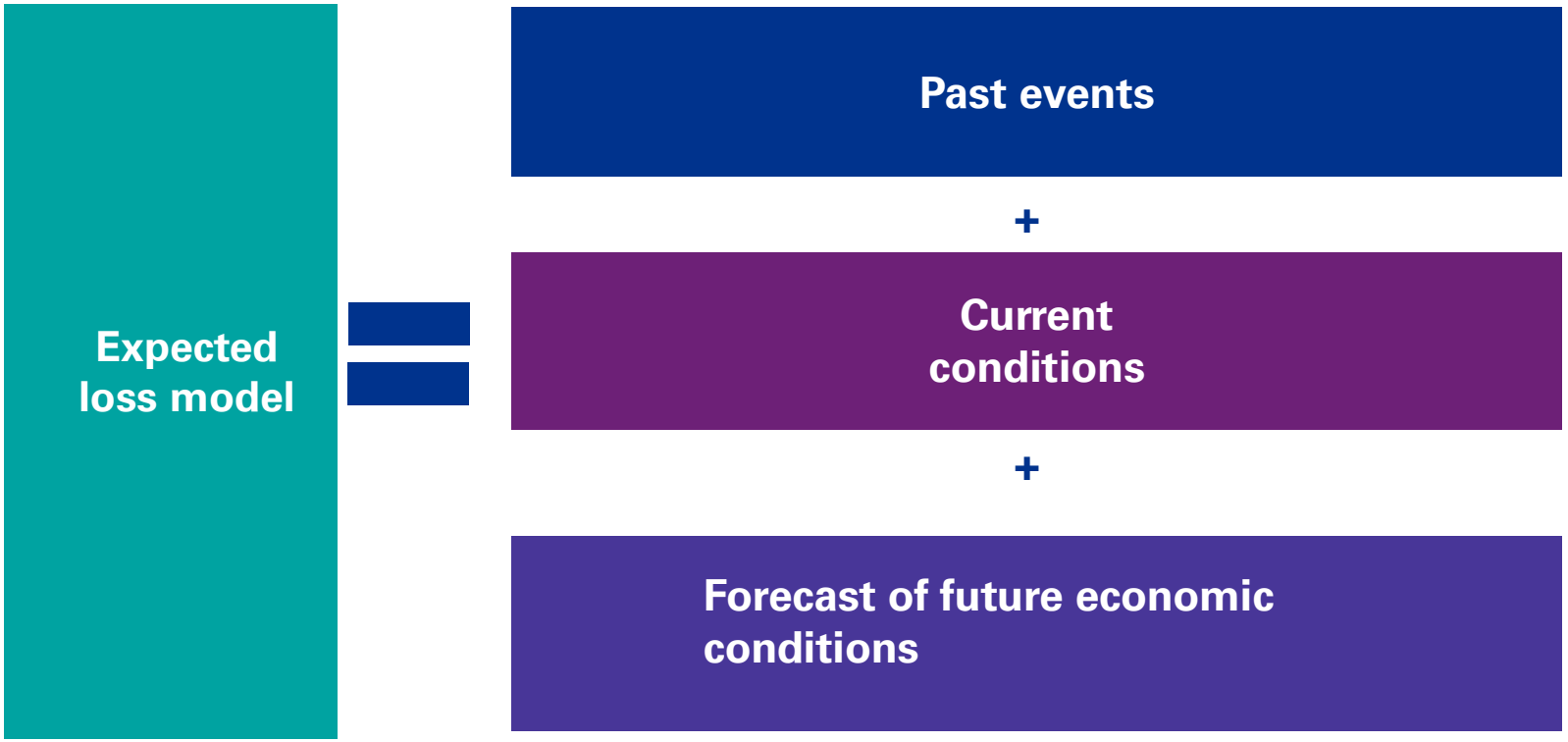
		Reclassification to:	
		FVOCI	**FVTPL**
Reclassification **from:**	**Amortised cost**	Remeasure at fair value, with any difference recognised in OCI	Remeasure to fair value, with difference between amortised cost and fair value recognised in P/L

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.

Impairment – the new model



Impairment - high level overview

EL = PD x LGD x EAD

EL

- Expected loss is a statistical measure used to reflect expectations of future losses based on historical data
- The three primary components are derived based on observation, empirical evidence and expert judgment
- The objective is to quantify loss expectations over a 12 month forecast

PD

- Probability of default for an asset or class of assets over the next year
- PD represents an average expectation over the course of an entire business cycle (through-the-cycle) as opposed to specific current expectations (point-in-time)

LGD

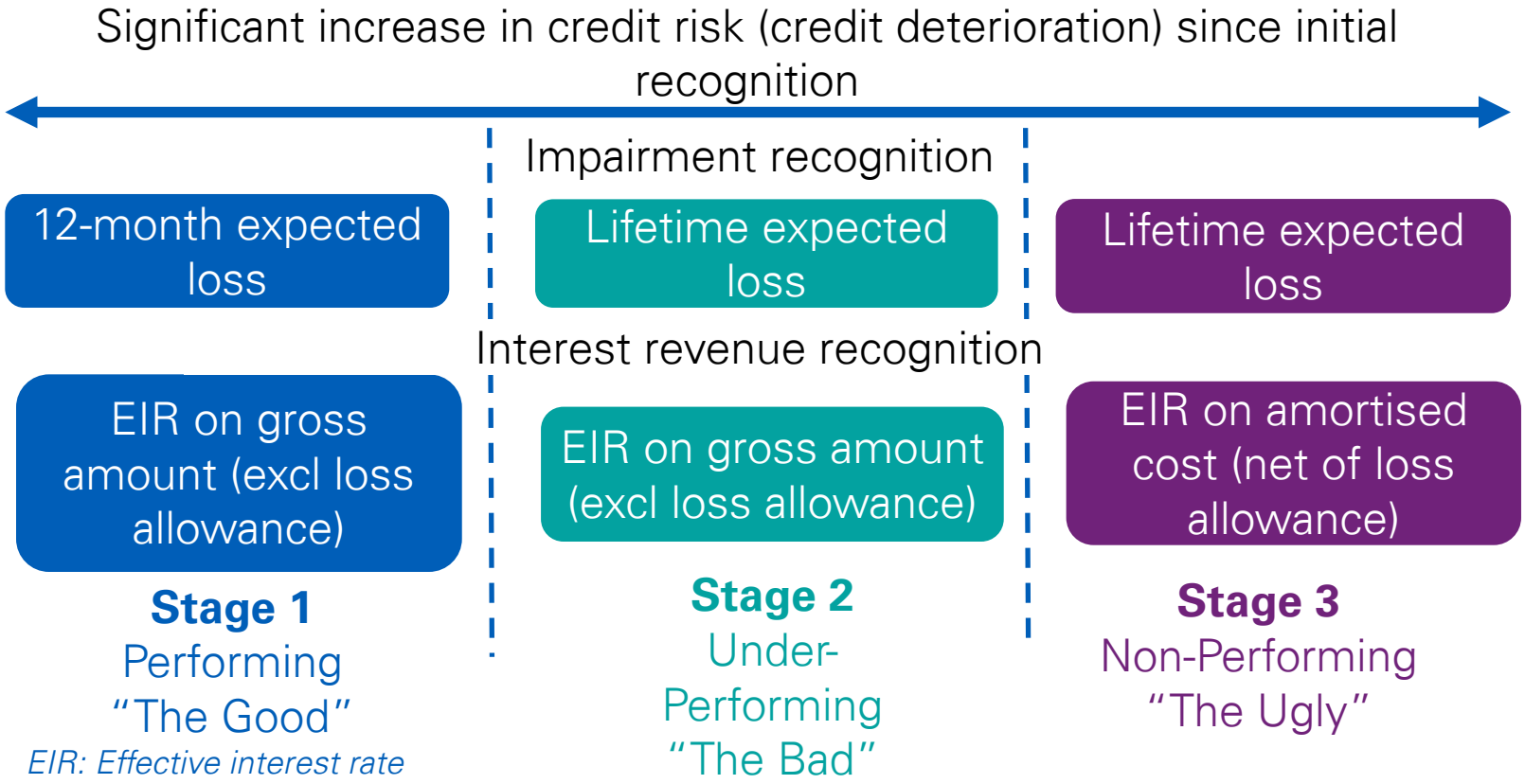
- Loss given default based on losses resulting from defaults over the next 12 months
- Ideally the LGD will be separated for secured and unsecured portions of an exposure
- LGD is a prudent parameter based on an assumed downturn in the economic conditions

EAD

- Exposure at default represents the amount a financial institution stands to lose in the event of a default event
- For a 12 month horizon, the EAD is defined as the current exposure without considering payments
- Undrawn commitments are factored in using statistical probabilities of drawing

- Changes to existing models are necessary to comply with lifetime expected credit loss (LECL) requirements

IFRS 9 ECL – General model



EIR: Effective interest rate

12-month ECLs are the portion of lifetime expected credit losses that represents losses resulting from default events that are possible within 12 months

Lifetime ECLs are the expected credit losses that result from all possible default events over the expected life of a financial instrument

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 x 10%).
B. CU 30 (100 x 30%)
C. CU 4 (40 x 10%)
D. CU 12 (40 x 30%)
E. CU 22 (100 x 10% + 40 x 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 (1st snapshot)	CU 15m	CU 7.5m	CU 4m	CU 2.5m	CU 1m
2nd 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: (2nd snapshot / 1st snapshot)	0.3%	1.6%	3.6%	6.6%	10.6%

Constructing default rates (3/3)

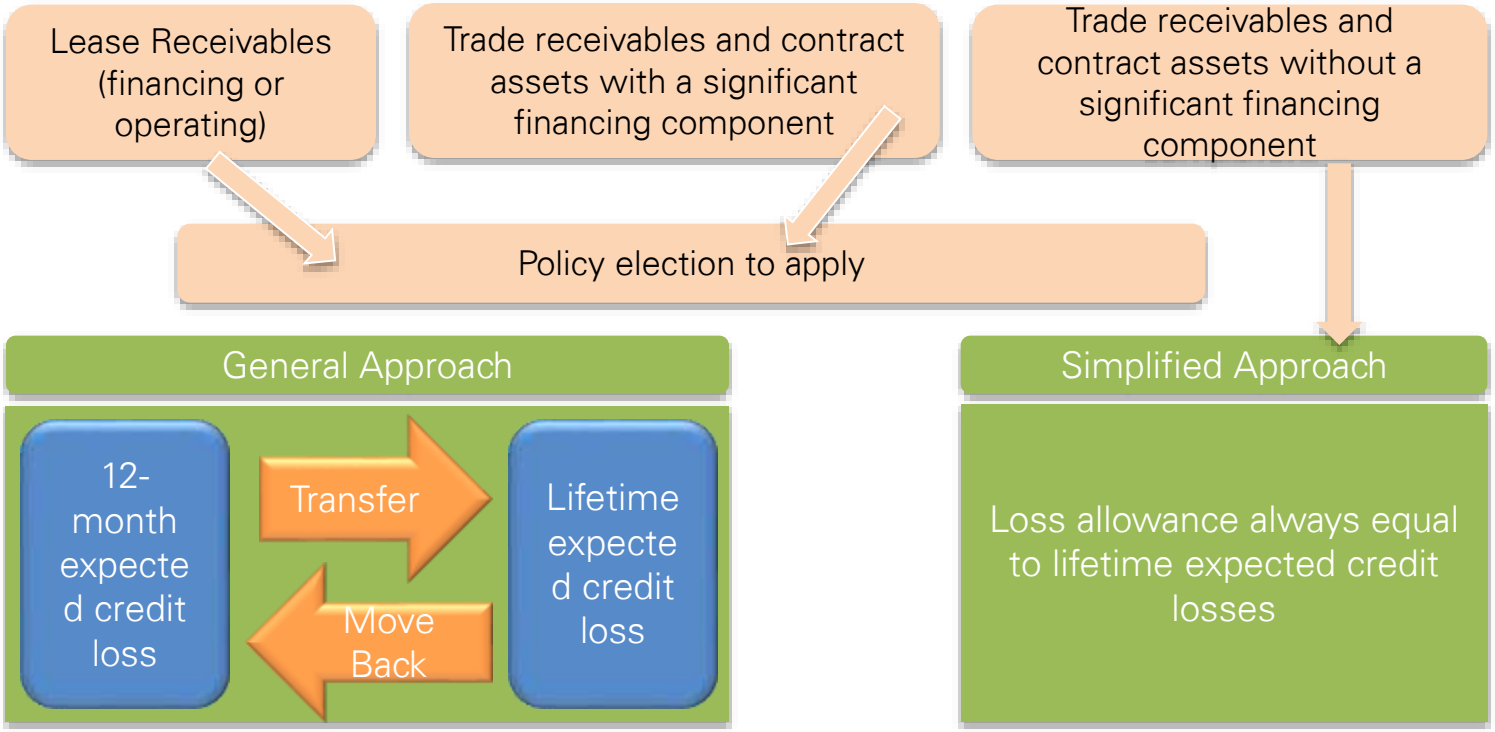
Due to Company M's nature of receivables (a large number of small clients, categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due and trade receivables do not have a significant financing component), the loss allowance for such trade receivables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

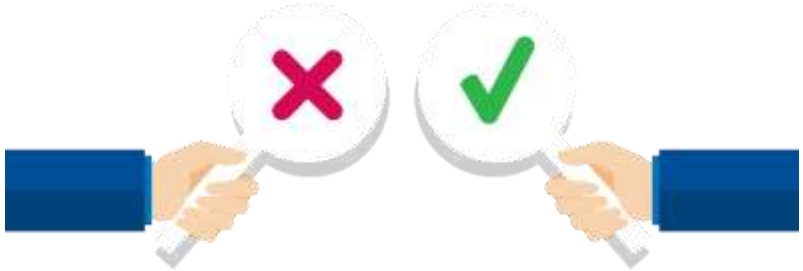
How do you calculate this percentage?

Provision matrix

Calculating the probability-weighted expected credit loss

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

Probability = event / 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.

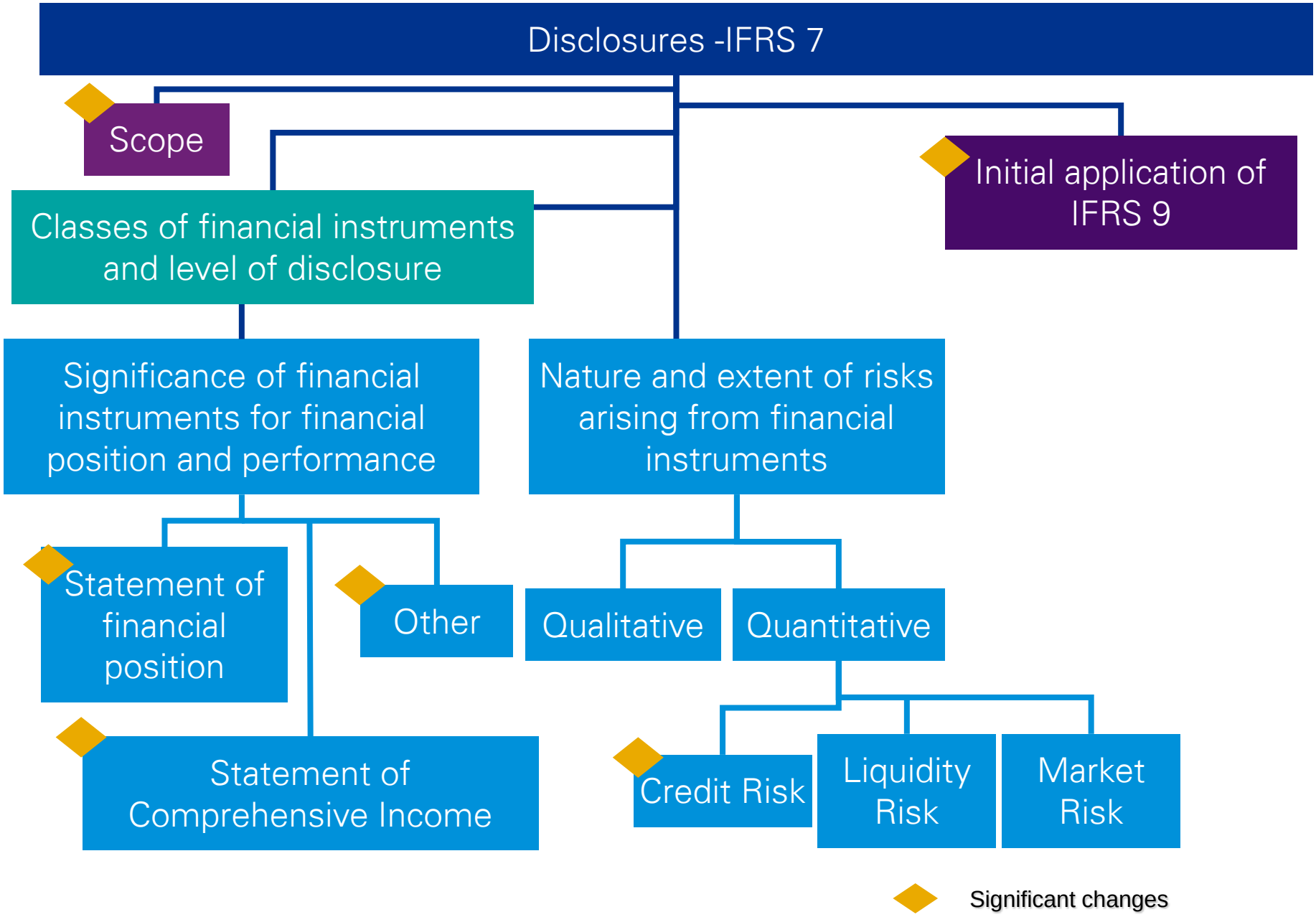
Provision matrix (cont.)

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
Total number of invoices	**1 450**

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.


Disclosures -IFRS 7
Scope
Classes of financial instruments and level of disclosure
Initial application of IFRS 9
Significance of financial instruments for financial position and performance
Nature and extent of risks arising from financial instruments
Statement of financial position
Other
Qualitative
Quantitative
Statement of Comprehensive Income
Credit Risk
Liquidity Risk
Market Risk
Significant changes

Initial application

Financial Asset Class: Amortised Cost	IAS39 carrying amount closing balance (i)	Reclassifications (ii)	Remeasurements (iii)	IFRS 9 carrying amount opening balance (iv) = (i) + (ii) + (iii)	Retained earnings effect opening balance (v) = (iii)
From available for sale (IAS 39)					
From at FVTPL (IAS 39) - elected, required or revoked by choice					
To FVTOCI (IFRS 9)					
To FVTOCI (IFRS 9) - elected or required					
Total change to Amortised cost					

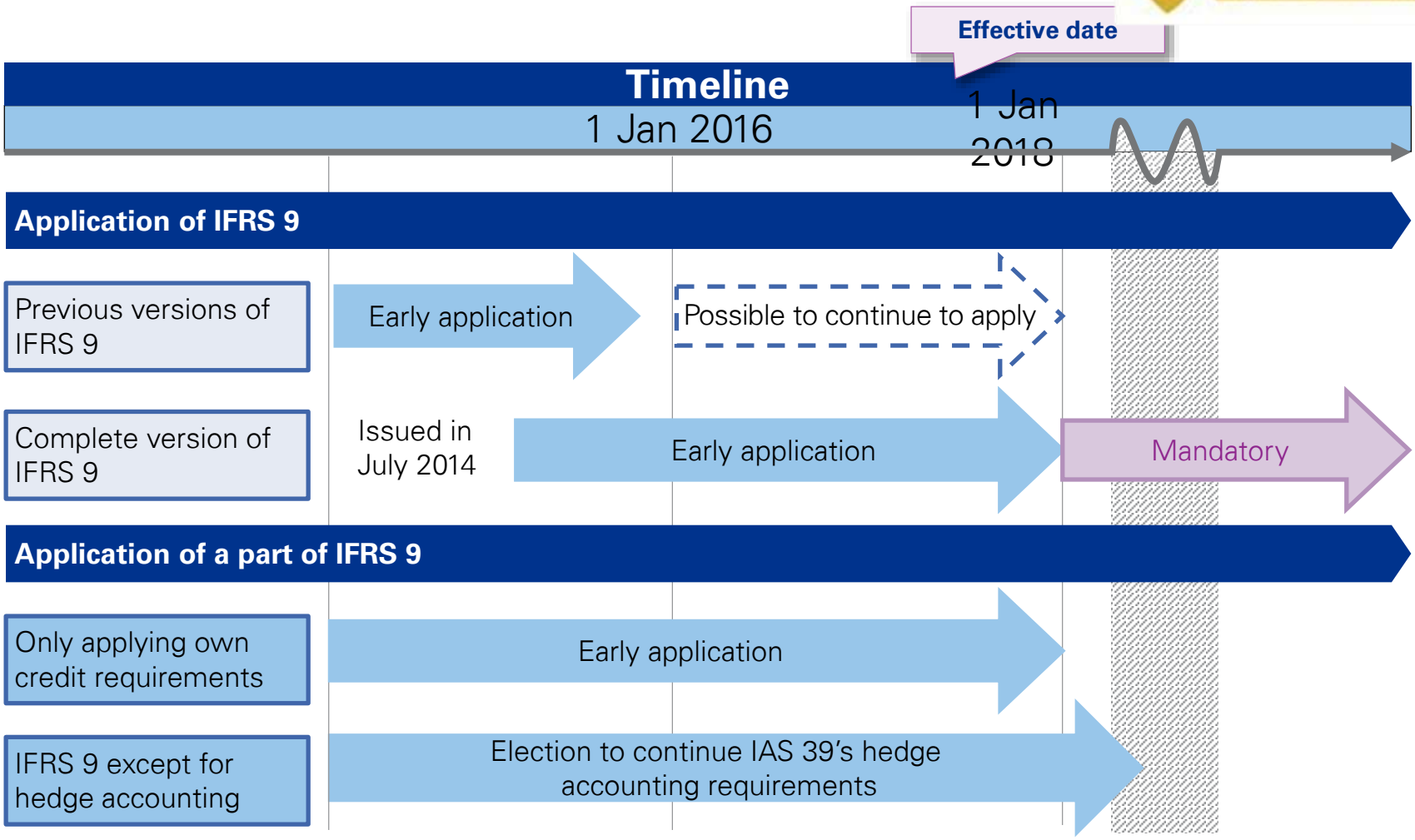
Gross carrying amount reconciliation

Trade receivables: Gross Carrying Amount	12-month expected credit losses	Lifetime expected credit losses			Totals
		Significant increase in credit risk	Credit impaired	Simplified approach	
Opening balance					
Changes:					
- Transfers due to change in credit risk					
- New financial assets originated/ purchased					
- Write-offs					
- Derecognition					
- Modification					
- Other					
Closing balance					

Loss allowance reconciliation

Loss Allowance per Financial Asset Class: Trade receivables	12-month ECL	Lifetime ECL			Totals
		Significant increase in credit risk	Credit impaired	Simplified approach	
Opening balance	x	x	x	x	x
- Transfers due to change in credit risk					
- New financial assets originated/ purchased					
- Write-offs					
- Derecognition					
- Modification					
- Other					
Closing balance	x	x	x	x	x
Total undiscounted expected credit losses at initial recognition					x

Effective date and transition



Retrospective application & restatement

An entity shall apply IFRS 9 retrospectively in accordance with IAS 8 *Accounting Policies, Change in Estimates and Errors*

Except

if certain assessments are impracticable

1 Jan 2018

Not restate

Retrospective application in opening RE in reporting period including DIA

Q&A