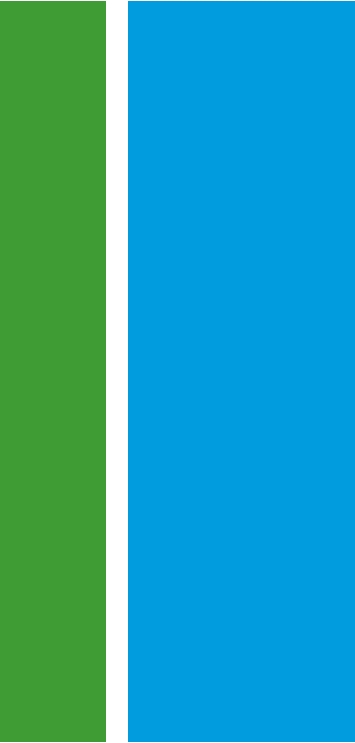


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FINANCIAL INSTRUMENTS

Efficient implementation of IFRS 9

IFRS 9 – Financial instruments

Agenda

- Overview
- Classification and measurement
- Impairment

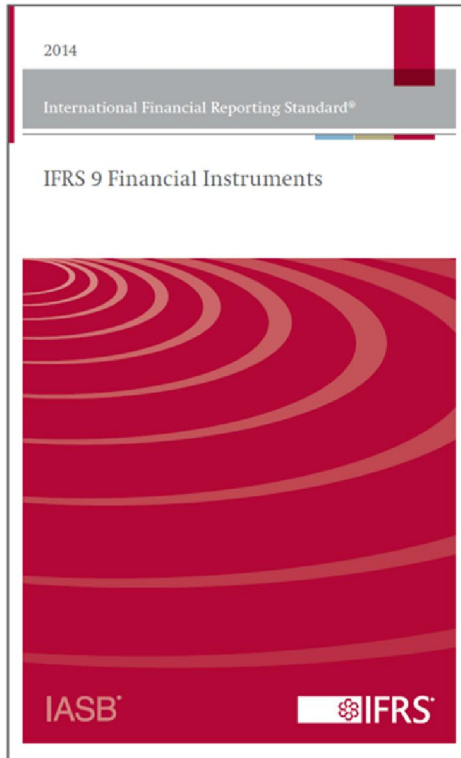
IFRS 9 – Financial instruments

Status

It has been released in instalments:

- Starting in November 2009 through to July 2014, when the complete standard was issued
- Effective date – accounting periods beginning on or after 1 January 2018 (put back progressively from 1 January 2013!)

A comprehensive Standard to replace IAS 39



Classification and measurement

- A logical, single classification approach for financial assets driven by cash flow characteristics and business model
- Improvements to “own credit” for financial liabilities

Impairment

- A much needed and strongly supported forward-looking ‘expected loss’ model

Hedge accounting

- An improved and widely welcomed model that better aligns accounting with risk management

IFRS 9 – Financial instruments

Scope

IFRS 9 applies to all financial instruments except:

- Interests in subsidiaries, associates, and joint ventures (IFRS 10, IFRS 11, IAS 27, and IAS 28)
- Rights and obligations under leases (IAS 17)
- Rights and obligations under employee benefit plans (IAS 19)
- Equity instruments of an issuer (IAS 32)
- Rights and obligations under insurance contracts (IFRS 4)
- Share-based payments (IFRS 2)
- Et al

IFRS 9 – Financial instruments

IFRS 9 and insurance companies

Companies whose business is predominantly insurance have two options as alternatives to applying IFRS 9 in full:

- **The deferral approach:** deferral of application of IFRS 9 until IFRS 17 is applied (mandatory from 1 January 2021)
- **The overlay approach:** comply with the classification and measurement requirements of IFRS 9 but any differences in measurement between IAS 39 and IFRS 9 can be recognised in other comprehensive income rather than profit or loss.



IFRS 9 - CLASSIFICATION AND MEASUREMENT

IFRS 9 – Financial instruments

Financial assets – Classification and measurement

Financial assets should be classified as measured either at amortised cost or fair value based on two criteria:

- The entity's business model for managing the financial assets; and
- The contractual cash flow characteristics of the financial asset.

IFRS 9 – Financial instruments

Financial assets – Classification and measurement

Financial assets should be measured **at amortised cost** if, and only if, both:

- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest; and
- The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

All other financial assets should be measured at fair value.

IFRS 9 – Financial instruments

Financial assets – Classification and measurement

Financial assets should be measured **at fair value through other comprehensive income** if both:

- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest; and
- The asset is held within a business model whose objective is achieved by both collecting contractual cash flows *and selling the assets*.

Interest would be recognised in profit or loss.

IFRS 9 – Financial instruments

Financial assets – Classification and measurement

All other financial assets should be measured at fair value through profit or loss

Except that for an investment in an **equity instrument** (that is not held for trading and is not an investment in subsidiary or associate) an entity may make an irrevocable election at initial recognition to present subsequent changes in fair value in other comprehensive income (dividends would be recognised in profit or loss). Gains/losses are **not** recycled to profit or loss when realised.

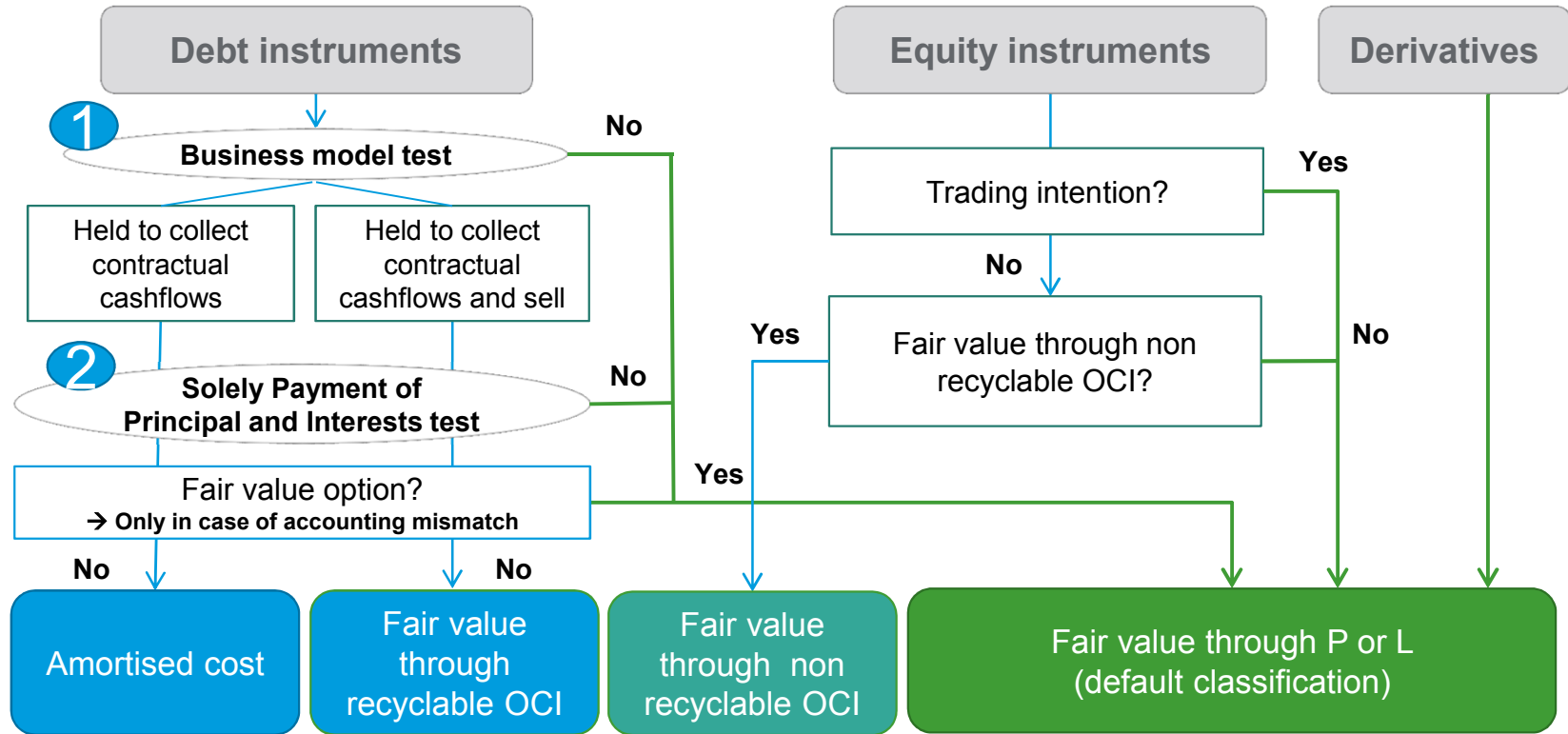
IFRS 9 – Financial instruments

Financial assets – Classification and measurement

Fair value option:

- Despite the above, an entity may, at initial recognition, irrevocably designate a financial asset at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch)

Classification and measurement decision tree



Transition – IAS 39 to IFRS 9

IAS 39 classification	IAS 39 measurement	IFRS 9 measurement
Fair value through profit and loss: Derivatives Financial instruments held for trading A portfolio of investments managed on a fair value basis	FVTPL	At FVTPL
Loans and receivables: Loans receivable Trade and other receivables Bonds not traded in an active market Bank deposits	AC	At AC, provided business model is to hold to collect cash flows and cash flows are principal and interest only. If not, at FVTPL

Transition – IAS 39 to IFRS 9

IAS 39 classification	IAS 39 measurement	IFRS 9 measurement
Held to maturity: Government and other bonds traded in an active market	AC, subject to tainting	At AC
Available for sale:		
Equities	FVTOCI	At FVTPL, or at FVTOCI by election on initial recognition
Bonds traded in an active market	FVTOCI	At FVTPL, or at AC if business model is to collect cash flows, etc, or at FVTOCI if business model is to hold or sell
Other instruments so designated	FVTOCI	At FVTPL, or at AC if business model is to collect cash flows, etc

IFRS 9 – Financial instruments

Financial liabilities – Classification and measurement

Financial liabilities should be classified as measured at amortised cost except for:

- Liabilities held for trading, including derivatives
- Those which the entity, at initial recognition, irrevocably designates as at fair value through profit or loss because:
 - doing so eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch); or
 - it forms part of a portfolio which is managed and evaluated on a fair value basis;
- Financial guarantee contracts
- Commitments to provide a loan at a below-market interest rate

which are measured at fair value

IFRS 9 – Financial instruments

Gains and losses on financial liabilities

Gains or losses on financial liabilities measured at fair value shall be recognised in profit or loss ...

...**except for** the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability, which shall be recognised in other comprehensive income (OCI)

IFRS 9 – Financial instruments

Reclassification

- An entity can reclassify **financial assets** when, and only when, it changes its business model for managing those assets. A transfer of an asset between business models within an entity is not a “change of business model”.
- Reclassification can only be applied prospectively from the start of the following reporting period.
- **Financial liabilities** cannot be reclassified.

IFRS 9 – Financial instruments

Transition – classification and measurement

- Determine the classification of financial assets and liabilities based on facts and circumstance existing at 1 January 2018.
- Decide on your accounting policy choice for equity investments
- Apply the measurement retrospectively, unless impracticable, but with the disclosures required by IFRS 7
- Restate comparatives only if it is possible to do so without the use of hindsight

IFRS 9 – Financial instruments

Transition – classification and measurement

For example:

- If an asset carried at amortised cost now has to be measured at fair value, the difference in carrying amount will be an adjustment to retained earnings at 1 January 2018
- If an asset measured at fair value through other comprehensive income is now classified at fair value through profit or loss, the cumulative fair value gains/losses will be transferred from the fair value (AFS) reserve to retained earnings at 1 January 2018

IFRS 9 – Classification and measurement

Actions

- Review all your financial instruments and identify those that will need to be reclassified. Pay particular attention to:
 - Do all financial assets measured at amortised cost meet the two criteria: held to collect the cash flows, which are solely principal and interest?
 - If you have equity investments, do you want to elect to measure these at fair value through other comprehensive income
 - Do you have other financial assets currently classified as available-for-sale, which are held to collect cash flows or sell, in which case they will continue to be carried at fair value through other comprehensive income.
- Agree your conclusions with your auditor, and if you have any complex instruments (e.g. embedded derivatives), seek further advice.



IFRS 9 - FINANCIAL ASSETS - IMPAIRMENT

IFRS 9 – Financial instruments

Impairment - overview

- Guiding principles
 - Based on expected credit losses, not incurred losses
 - Responsive to changes in information that impact credit expectations
 - Credit losses should be based on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and forecast information

IFRS 9 – Financial instruments

Impairment – financial instruments affected

- Financial assets at amortised cost (including trade receivables)
- Lease receivables
- Debt instruments at fair value through other comprehensive income (hold and sell)
- Loan commitments (undrawn) and financial guarantee contracts

IFRS 9 – Financial instruments

Impairment

Recognise expected credit losses using a 3 stage approach based on change in credit quality since initial recognition:

1. As long as credit risk has not increased significantly since initial recognition – recognise 12 month expected credit losses
2. If credit risk has increased significantly since initial recognition – recognise lifetime expected credit losses. Continue to recognise interest on gross carrying amount
3. Impaired - recognise lifetime expected credit losses, and recognise interest only on the recoverable amount

For simple trade receivables and lease receivables, loss allowance should equal life time expected credit losses.

IFRS 9 – Financial instruments

Impairment

12 month expected credit losses are the portion of lifetime expected credit losses that represent the expected credit losses that result from default events that are possible within 12 months from the reporting date

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

IFRS 9 – Financial instruments

Impairment

Expected credit losses are a probability-weighted estimate of credit losses, i.e.

Expected credit loss = probability of default x amount of credit loss

A credit loss is the present value of the difference between the contractual cash flows and the cash flows that the entity expects to receive.

IFRS 9 – Financial instruments

Measurement of expected credit losses

The *amount of credit loss* can also be expressed as:

Exposure at default x loss given default (expressed as a percentage)

An alternative is the 'loss rate approach'. Under this approach an entity considers samples of its own historical default and loss experience to arrive at a loss rate percentage.

It then updates its historical data for current economic conditions as well as reasonable and supportable forecasts of future economic conditions.

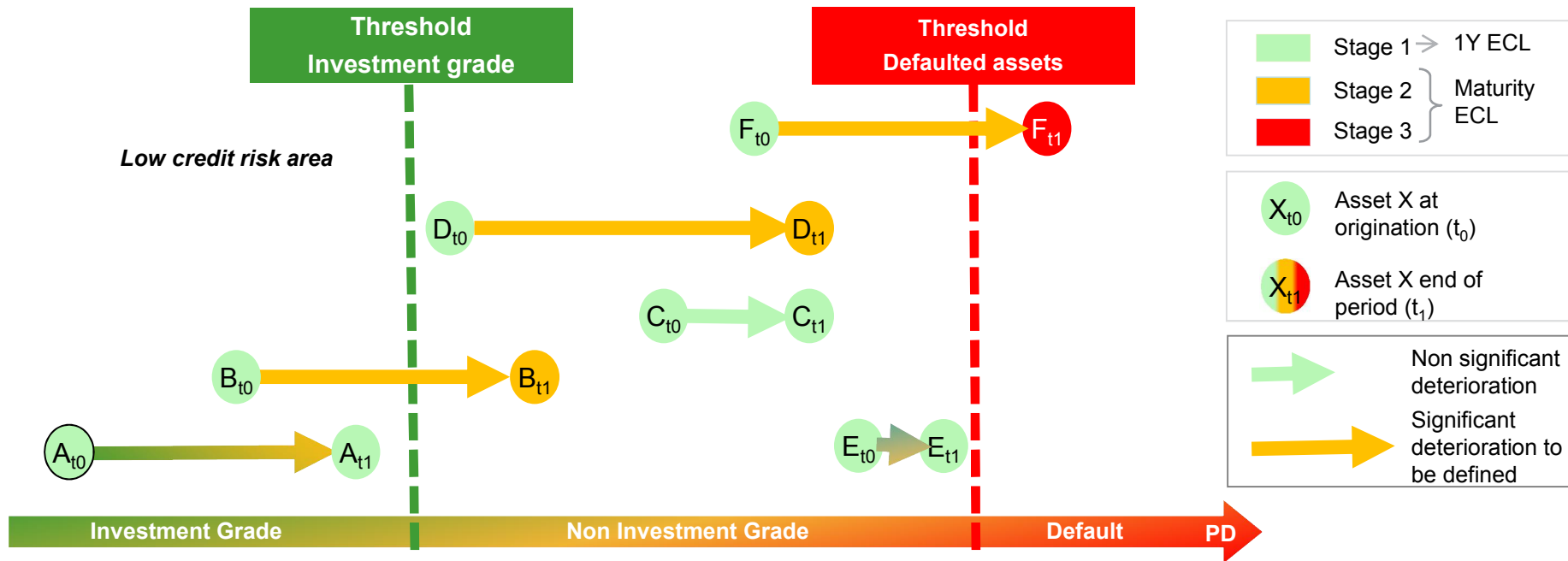
IFRS 9 – Financial instruments

How to determine whether credit risk has increased significantly

- Based on changes in risk of default over the remaining life of the instrument rather than changes in the amount of expected losses
- Reasonable and supportable information that is available without undue cost or effort must be used, for example:
 - Actual or expected significant change in FI's external credit rating
 - Actual or expected internal credit rating downturn
 - Actual or expected significant change in the operating results of the borrower
 - Existing or forecast adverse changes in business, financial, or economic conditions
 - Significant changes in the value of the collateral supporting the obligation
- But there is a rebuttable presumption that there has been a significant increase in credit risk when payments are more than 30 days past due

Impairment: credit risk deterioration

Assess credit risk deterioration: what is your opinion?



Simplifications and exceptions to the general model

Low credit risk

- choice to assume no significant increase in credit risk (remain in stage 1)

30 Days Past Due

- rebuttable presumption => significant increase in credit risk (move to stage 2)

90 Days Past Due

- rebuttable presumption => default has occurred (move to stage 3)

Lifetime ECL must be recognised for:

- Trade receivables & contract assets that do not contain a significant financing component
- Purchased or Originated Credit Impaired financial assets

Accounting policy choice to always recognise lifetime ECL for:

- Trade receivables & contract assets that contain a significant financing component
- Lease receivables

Impairment calculation

Illustrative example #1

- Calculation of the 1Y ECL
 - Loan of 1,000, with a 5 year maturity, with a loss given default of 30% and a BBB rating
 - Below, the cumulative PD « corporate » grid according to Standard & Poors:

Rating	1 Y	2 Y	3 Y	4 Y	5 Y
BBB	0.24	0.67	1.13	1.71	2.30

- Solution
 - The amount of impairment is calculated this way:
 - $1000 \times 30\% \times 0.24\% = 0.72$

Impairment calculation

Illustrative example #2

- One year later, a significant credit risk deterioration is identified (BBB → BB) : calculation of the maturity ECL
 - Loan of 1,000, with a 5 year maturity, with a loss given default of 30% and a BBB rating
 - Below, the cumulative PD « corporate » grid according to Standard & Poors:

Rating	1 Y	2 Y	3 Y	4 Y
BB	0.90	2.70	4.80	6.80

- Solution
 - The amount of impairment calculated is now:
 - $1,000 \times 30\% \times 6.80\% = 20.40$
 - Which means an additional loss in the P&L of $(20.40 - 0.72) = 19.68$
 - You may observe that the increase of impairment is exponential in case of significant credit risk deterioration.

Practical application for trade receivables

- Company M, a manufacturer, has a portfolio of trade receivables of CU30 million in 20X1 and operates only in one geographical region.
- The customer base consists of a large number of small clients.
- The trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms.
- The trade receivables do not have a significant financing component.
- The following pattern of default is based on historical default rates of the trade receivables, and adjusted for forward looking estimates (e.g. deteriorating economic conditions.)

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

Calculating the provision

	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due	Total
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%	
Carrying amount at year end	15,000,000	7,500,000	4,000,000	2,500,000	1,000,000	30,000,000
Lifetime expected credit loss allowance	45,000	120,000	144,000	165,000	106,000	580,000

Practical application for trade receivables

- At 31/12/20X2, M's portfolio of trade receivables has increased to CU34 million
- Company M revises its forward looking estimates and expects general economic conditions to be worse than expected at 31/12/20X1
- Company M estimates 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
0.5%	1.8%	3.8%	7%	11%

Calculating the provision

	Current	1–30 days past due	31–60 days past due	0.3%	More than 90 days past due	Total
Default rate	0.5%	1.8%	3.8%	7%	11%	
Carrying amount at year end	16,000,000	8,000,000	5,000,000	3,500,000	1,500,000	34,000,000
Lifetime expected credit loss allowance	80,000	144,000	190,000	245,000	165,000	824,000

The provision has therefore increased from CU540,000 to CU824,000

Determining historical default rate - example

	Aged analysis of receivables at 31/12/2011 CU	Not recovered after 3 years CU	Historical default rate %
0-30 days	9,136,251	65,802	0.7
31-60 days	1,272,838	18,760	1.5
61-90 days	969,256	149,007	15.4
Over 90 days	2,671,695	602,785	22.6
Total	14,050,040		

Repeat the same exercise at, say, 31/12/2012 and 31/12/2013 and work out the average historical default rates.

Implementation of IFRS 9

Tax implications

- Stage 1 and Stage 2 expected credit losses will be 'general' provisions and will not be tax deductible (will result in a deferred tax asset)
- Stage 3 provisions should be treated in the same way as they have been under IAS 39
- Fair value gains and losses will generally be 'added back' in the tax computation. It will then be necessary to track and tax realized gains and losses
- The need to determine what are 'trading' gains and what are 'capital' gains from investments remains unchanged

Implementation of IFRS 9

Transition - impairment

- At 1 January 2018 it will be necessary to determine whether there has been a significant increase in credit risk since the initial recognition of the asset without undue cost or effort, recognise lifetime expected credit losses, unless it is low credit risk
- Determine impairment provisions as at 1 January 2018, and adjust retained earnings accordingly
- Restate comparatives only if it is possible to do so without the use of hindsight

Implementation of IFRS 9

Beware of transition issues!

- Mandatory effective date
 - annual periods beginning on or after 1 January 2018
 - will apply to quarterly/half year reporting after 1 January 2018
 - retrospectively with transitional provisions (no restatement of comparatives required re impairment)
- Expected to be very challenging for financial institutions
 - start assessing effect asap!
- Provisions can only go up – expected losses are being added to incurred losses
- Probability of default is never zero – but might result in immaterial provisions (e.g. investment in government securities)

IFRS 9 brings in extensive new disclosure requirements

Ongoing disclosures

- Classification and measurement
 - updated accounting policies (including info on the entity's business models)
 - listing of each equity instrument elected at FVTOCI
- Impairment
 - updated accounting policies
 - quantitative information on loss allowance calculation
 - detailed reconciliations of the loss allowance

On transition

- Reconciliation of the closing balances under IAS 39 to the opening IFRS 9 balances for all financial assets, financial liabilities and any loss allowances
- If comparatives are not restated ^[1], accounting policies
 - under IFRS 9 for current period, and
 - under IAS 39 for comparative period

^[1] Comparatives can only be restated if it is possible to avoid the use of hindsight

IFRS 9 - Implementation

Actions – that you should have already taken!

- Read the standard and the guidance
- Start extracting historical data to support estimates of probability of default, even for trade receivables – go back at least 5 years
- Determine provisions under IFRS 9 at 31 December 2017 before completion of the 2017 audit (assuming a 31 December year-end) – so that ‘impact’ can be disclosed in accordance with IAS 8

For insurance companies

- Need to recognise expected credit losses on all financial assets:
 - Government securities
 - Corporate bonds and commercial paper
 - Loans and receivables
- This might impact solvency ratios

For banks

- Need to recognise expected credit losses on all financial assets:
 - Loans and advances (based on exposure at default)
 - Government securities
 - Corporate bonds and commercial paper
 - Financial guarantees and loan commitments
- Impact will be more on opening retained earnings than profit or loss. This may be partly or wholly offset by reduction in regulatory reserve, but is likely to impact on capital adequacy ratios. CBK is allowing a 5 year transition to the full impact of IFRS 9 when calculating capital adequacy.

QUESTIONS AND ANSWERS?

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THANK YOU