Financial Instruments

Classification and Measurement under IFRS 9

Uphold public interest

CPA Anthony M. Njiru
0722241005

IFRS 9 affects

Credit Losses	Reported credit losses are expected to increase
Classification & measurement	Classification of financial assets becomes more judgmental
Disclosures	Extensive new disclosures are required

Financial Instrument

Financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity

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.

Fair Value

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

Financial Assets Components

Financial instrument assets may be

- a debt asset which will be received some time in the future for example, an investment in another entity's debentures, or
- an equity asset for example, an investment in another entity's shares, but not an investment in a subsidiary, associate, joint venture nor pension fund

Financial assets: subsequent measurement

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

- Amortized cost;
- Fair value through other comprehensive income (FVTOCI); or
- Fair value through profit or loss (FVTPL).

Amortized cost

Amortized cost is that accumulated portion of the recorded cost of a fixed asset that has been charged to expense through either depreciation or amortization.

Debt Instrument

A **debt instrument** is a paper or electronic obligation that enables the issuing party to raise funds by promising to repay a lender in accordance with terms of a contract.

Examples Of Debt Instruments

Debt instruments include

- Notes
- Bonds
- Debentures
- Certificates
- Mortgages
- leases or other agreements between a lender and a borrower.

Initial Measurement - Debt

Initial measurement is at fair value and includes transaction costs

[redacted]

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

Whilst for equity investments, the FVTOCI classification is an election.

Subsequent Measurement – Debt

Debt Instruments at Amortised Cost

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

- Business model test:
- Cash flow characteristics test

All other debt instrument assets are measured at fair value through profit or loss (FVTPL)

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

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.

Debt Instruments At FVTOCI

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

Business Model test

Cash flow characteristics test

Business Model Test

Business model test The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

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.

Fair value option

IFRS 9 contains an option to designate, at initial recognition, a financial asset as measured at FVTPL if doing so eliminates or significantly reduces an ‘accounting mismatch’ that would otherwise arise

Subsequent measurement - Summary

Subsequent measurement is either at:

- amortised cost, or
- fair value

Summary - Continued

a debt asset may only be valued at amortised cost if it satisfies both of two tests

- the business model test – the asset is held with the intention of realising its cash fows rather than being held for early sale, and
- the cashflow characteristics test – the asset terms are such that cashflows will arise on specific dates in the future representing interest payments and repayments of principal

Summary - Continued

if either one of these tests is not satisfied, the asset must be classified as at FVTPL

-Even if both tests are satisfed, nevertheless the asset may be valued at FVTPL if, by doing so, it eliminates or signifcantly reduces an inconsistency in measurements (the fair value option)

- annual changes in value go through statement of profit or loss

Change From IAS 39

The FVTOCI category for debt instruments is not the same as the available-for-sale category under IAS 39.

Under IAS 39, impairment gains and losses are based on fair value, whereas under IFRS 9, impairment is based on expected losses

Change From IAS 39

criteria for measuring at FVTOCI are based on the entity's business model, which is not the case for the available-for-sale category.

For example under IAS 39, certain instruments can be elected to be classified as available-for-sale, whereas under IFRS 9 the FVTOCI classification cannot be elected for debt instruments.

Note: Cash Flow Characteristic

Only debt instruments are capable of meeting the contractual cash flows characteristics test required by IFRS 9.

Derivative assets and investments in equity instruments will not meet the criteria.

Embedded Derivatives

Under IFRS 9 assets managed on a fair value basis are by default accounted for at FVTPL because they fail the business model test.

Hybrid debt instruments that are financial assets with non-closely related embedded derivatives would also be accounted for at FVTPL under IFRS 9.

Equity Instrument

Equity instrument is a contract that represents a unit of residual interest in the assets of the entity after deducting all its liabilities.

Equity investments - Measurement

All equity investments in scope of IFRS 9 are measured at fair value in the statement of financial position, with value changes recognized in profit or loss, except for those equity investments for which the entity has elected to present value changes in other comprehensive income.

Equity investments

The option to designate an equity instrument at FVTOCI is available at initial recognition and is irrevocable.

This designation results in all gains and losses being presented in OCI except dividend income which is recognised in profit or loss

Equity assets - Summary

- These are measured at fair value
- with any change in value being reflected in statement of proft or loss
- Unless an election is made at the date of acquisition to deal with changes in value through the statement of other comprehensive income (FVTOCI)
- such an election cannot be changed – it’s irrevocable
- So, if the election is made, only the dividend income from the investment will be recognized within the statement of profit or loss

Equity assets - Summary

If the investment was made with the intention of trading those shares, then it is not possible to elect to classify the investment as at FVTOCI

On disposal, gains and losses previously recognized through statement of other comprehensive income cannot be recycled through the statement of profit or loss

Instead, on disposal, previously recognized gains and losses will be transferred to retained earnings through the statement of changes in equity

Cost Exception In IAS 39

This cost exception is not included in IFRS 9. However, IFRS 9 contains guidance on when cost may be the best estimate of fair value and also when it might not be representative of fair value.

Observation

Dividend income is recognised in profit or loss, all other gains and losses are recognised in OCI without reclassification on derecognition.

This differs than the treatment of AFS equity instruments under IAS 39 where gains and losses recognized in OCI are reclassified on derecognition or impairment.

Derecognition of financial assets

determine whether the asset under consideration for derecognition is:

- an asset in its entirety or specifically identified cash flows from an asset
- or a fully proportionate (pro rata) share of the cash flows from an asset

Derecognition

Once the asset under consideration for derecognition has been determined, an assessment is made as to whether the asset has been transferred, and if so, whether the transfer of that asset is subsequently eligible for derecognition.

Reclassification

If an election was made to classify as at FVTOCI, then that asset cannot be reclassified

If the fair value option has been exercised for a debt asset, that too cannot be reclassified

Reclassification

But if the business model objective has changed, a debt asset instrument may be reclassified between FVTPL and amortized cost, and vice versa

Such a reclassification does not operate retrospectively, so any previously recognized gains or losses are not restated

Financial Liabilities

A contractual obligation: to deliver cash or another financial asset to another entity; or. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity

Examples - Financial Liabilities

a financial instrument liability arises, for example, when a purchaser of goods or services on credit receives an invoice from the supplier

- Notes
- Bonds
- Debentures
- Certificates
- Mortgages

Financial Liabilities Treatment

These may be classified as either

- at amortized cost or
- at FVTPL

Initial measurement

Initial measurement is at fair value less any related transaction costs

Subsequent Measurement

IFRS 9 doesn't change the basic accounting model for financial liabilities under IAS 39. Two measurement categories continue to exist: FVTPL and amortised cost. Financial liabilities held for trading are measured at FVTPL, and all other financial liabilities are measured at amortised cost unless the fair value option is applied.

Fair value option

IFRS 9 contains an option to designate a financial liability as measured at FVTPL if

- doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch')
- the liability is part or a group of financial liabilities or financial assets and financial liabilities that is managed
- A financial liability which does not meet any of these criteria may still be designated as measured at FVTPL when it contains one or more embedded derivatives

Amortised Cost

if at amortised cost (applicable to the majority of financial instrument liabilities) consider the effective rate compared with the nominal (coupon) rate

Gains/Losses On FVTPL

IFRS 9 requires gains and losses on financial liabilities designated as at FVTPL to be split into the amount of change in fair value attributable to changes in credit risk of the liability, presented in other comprehensive income, and the remaining amount presented in profit or loss

Gains/Losses On FVTPL

The new guidance allows the recognition of the full amount of change in the fair value in profit or loss only if the presentation of changes in the liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss. That determination is made at initial recognition and is not reassessed.

Gains/Losses On FVTPL

Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss, the entity may only transfer the cumulative gain or loss within equity.

Derecognition of financial liabilities

A financial liability should be removed from the balance sheet when, and only when,

- It is extinguished, that is, when the obligation specified in the contract is either discharged or cancelled or expires.
- Where there has been an exchange between an existing borrower and lender of debt instruments with substantially different terms

Derecognition of financial liabilities

- there has been a substantial modification of the terms of an existing financial liability, this transaction is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability

Gain/loss on Derecognition

A gain or loss from extinguishment of the original financial liability is recognized in profit or loss

General Note for SACCOs Loans and advances

Generally classified at amortised cost

Interest recognized as an income at the effective rate

Loan collections are not an income in SACCO books

General Note for SACCOs Shares In Apex Bodies

Generally classified at Fair value through other comprehensive income

Dividends recognized as income

Changes in fair value recognized in other comprehensive income

General Note for SACCOs Deposits From Members

Generally classified at amortised cost

Interest recognized as an expense at the effective rate

Deposits are not an income in SACCO books

IFRS 9

- Impairment of financial assets
- Expected credit loss provisioning

CPA Anthony M. Njiru
0722241005

Impairment Of Loans

Amount by which the carrying amount of an asset or cash-generating unit exceeds its recoverable amount

Objective of Impairment

- **To ensure that assets are carried at no more than their recoverable amount**

IAS 39 Incurred loss model

IAS 39 states that a financial asset is impaired and impairment losses are incurred only if a loss event has occurred and this loss event had a reliably measurable impact on the future cash flows. This is often called the 'incurred loss' approach.

Advantage Of ICL

The incurred loss approach has the advantage of being fairly objective – there has to have been a past event – for example, an actual default or a breach of a debt covenant.

This objectivity reduces the risk of profit smoothing by companies

Limitation Of ICL

However, the incurred loss model has attracted criticism because it can result in the overstatement of both assets and profits.

Arguably the incurred loss approach was a contributory factor in the credit crunch 2007 - 2008.

Impairment Under IFRS 9

IFRS 9 establishes a new model for recognition and measurement of impairments in loans and receivables that are measured at Amortized Cost or FVOCI—expected credit losses model

Expected credit losses

Expected credit losses are calculated by:

(a) Identifying scenarios in which a loan or receivable defaults

(b) Estimating the cash shortfall that would be incurred in each scenario if a default were to happen

(c) Multiplying that loss by the probability of the default happening; and

(d) Summing the results of all such possible default events.

Recognition and measurement of expected credit losses

ICPAK
Credibility. Professionalism. Accountability

Expected losses are recognized and measured according to one of three approaches

- General approach
- Simplified approach
- Credit adjusted approach

Expected Loss Approaches

	General approach	Simplified approach	Credit adjusted approach
Applies to	All other loans and receivables not covered by another approach	Qualifying trade receivables, IFRS 15 contract assets and lease receivables	Assets that are credit impaired at initial recognition
Timing of initial recognition	Same period as asset is acquired	Same period as asset is acquired	Cumulative change in Lifetime ECLs since initial recognition
Measurement basis of the loss allowance	12 month ECLs (or Lifetime ECLs if the term of the asset is shorter) unless a significant increase in credit risk occurs, then Lifetime ECLs unless the increase reverses	Lifetime ECLs	Cumulative change in Lifetime ECLs since initial recognition

Calculating expected credit losses

In measuring expected credit losses an entity must reflect:

- An unbiased evaluation of a range of possible outcomes and their probabilities of occurrence.
- Discounting for the time value of money.
- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

The simplified approach

- For qualifying trade receivables, contract assets within the scope of IFRS 15 and lease receivables
- For these assets an entity can, or in one case must, recognize a loss allowance based on Lifetime ECLs
- The simplified approach does not apply to intercompany loans.

The credit adjusted approach

The credit adjusted approach applies only rarely when an entity acquires or originates a loan or receivable that is "credit impaired" at the date of its initial recognition (e.g., when a loan is acquired at a deep discount due to credit concerns via a business combination).

Examples in IFRS 9 of evidence that an asset is credit-impaired

- Significant financial difficulty of the issuer or borrower
- A breach of contract, such as a default or past due event (i.e., a borrower has failed to make a payment when contractually due)
- The lender, for economic or contractual reasons relating to the borrower's financial difficulty, has granted a concession that the lender would not otherwise consider
- It is becoming probable that the borrower will enter bankruptcy or other financial reorganization
- The disappearance of an active market for that financial asset because of financial difficulties
- The purchase or origination of a financial asset at a deep discount that reflects incurred credit losses

The general approach

Identifying whether a significant increase in credit risk has occurred

This is the trigger which causes the entity to change the basis of its calculation of the loss allowance from 12 month ECLs to Lifetime ECLs. To determine whether such an increase has occurred, an entity must consider reasonable and supportable information n that is available without undue cost or effort,

Certain key presumptions apply in performing this test:

- An entity may assume that credit risk has not increased significantly if a loan or receivable is determined to have "low credit risk" - adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations.

- If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information.
- There is a rebuttable presumption that the credit risk has increased significantly when contractual payments are more than 30 days past due.

General approach –Stage 1 Impairment

Level 1/Bucket 1 : For loans without signs of credit impairment, i.e. loans never in arrears ≥30 days. Bucket 1 recognizes expected losses within the next 12 months.

General approach –Stage 2 Impairment

Bucket 2: For loans that have signs of credit impairment—i.e. the loan has been in arrears for ≥30 days at least once (even if later cured)—but have not met the criteria for level 3

Bucket 2 recognizes lifetime expected losses.

General approach –Stage 3 Impairment

Level 3/ Bucket 3: For loans with serious credit impairment as well as large exposures with a history of arrearage.

Recognizes lifetime expected losses.

Interest income is not recognized (it is impaired)

SASRA Guideline

COs were able to fully maintain the prescribed

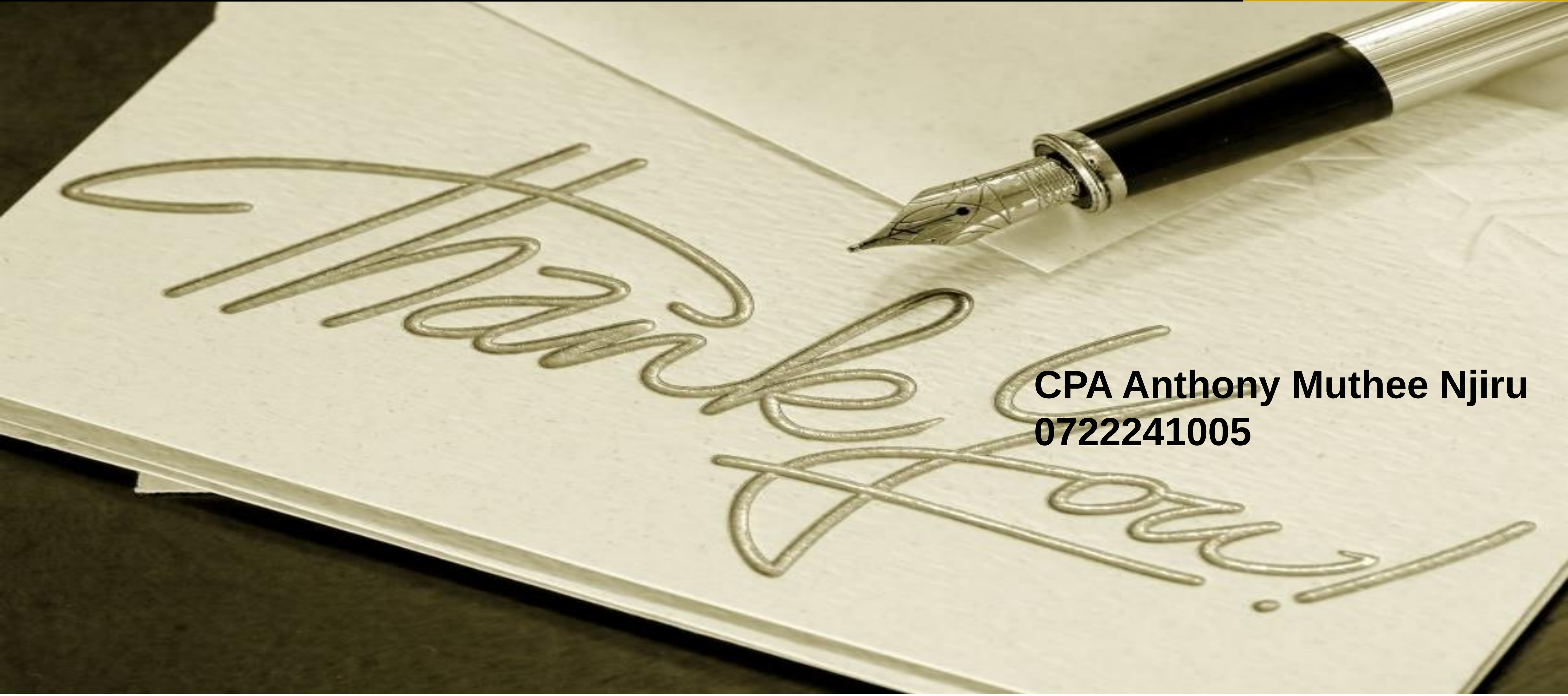
	RISK CLASSIFICATION OF ASSETS AND PROVISIONING				
	NAME OF SACCO SOCIETY		CNS NO……………….		
	FINANCIAL YEAR				
	START DATE:				
	END DATE:				
	PORTFOLIO AGEING REPORT				
		A	**B**	**C**	**D**
NO.	**CLASSIFICATION**	**NO. OF A/Cs**	**OUTSTANDING LOAN PORTFOLIO(Kshs)**	**REQUIRED PROVISION**	**REQUIRED PROVISION AMOUNT(Kshs)**
1	Performing			1%	
2	Watch			5%	
3	Substandard			25%	
4	Doubtful			50%	
5	Loss			100%	
	subtotal				
	Reschedule/Renegotiated loans				
1	Performing			1%	
2	Watch			5%	
3	Substandard			25%	
4	Doubtful			50%	
5	Loss			100%	
	subtotal				
	GRAND TOTAL				

Note: This return should be received on or before the 15th day of the month following end of every quarter

INTERACTIVE SESSION

CPA Anthony Muthee Njiru
0722 241 005

And Finally……



CPA Anthony Muthee Njiru
0722241005