

IFRS 9 and IFRS 16

Presentation by:

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Presentation agenda



IFRS 9, Financial instruments

- ☐ Overview of the requirements of IFRS 9
- ☐ Key issues for consideration
- ☐ Regulatory requirements in relation to the Standard
- ☐ Discussion and forum for questions

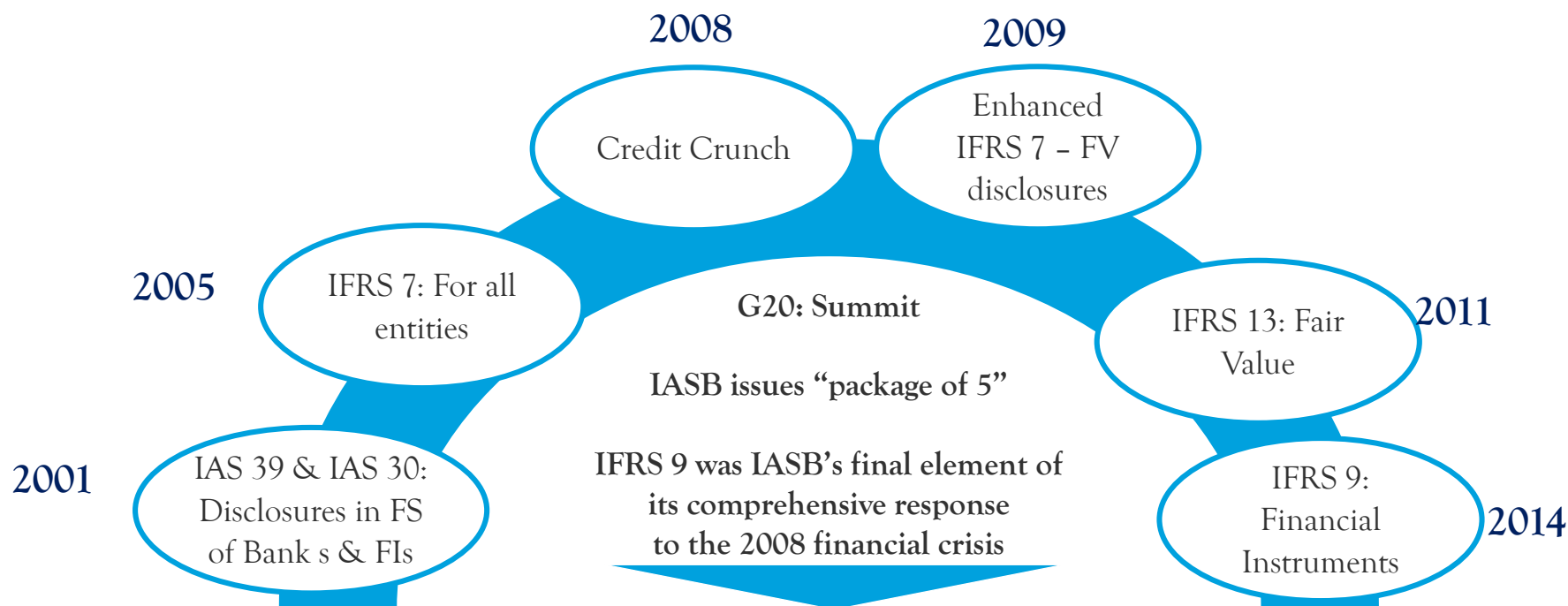
IFRS 9 – The auditor's perspective

Financial Instruments – Accounting History



Financial Instruments - Accounting History

How it all happened



Year	2001	2002	2003	2005	2006	2007	2008	2009	2010	2011	2012	2013
FED rate	6%	1.75%	1.25%	2%	4%	5.75%	3%	0.5%	0.5%	0.5%	0.5%	0.5%

IASB's Response to the 2008 Financial Crisis



Final piece of the Jigsaw

IFRS 7: Financial
Instruments:
Disclosures

IFRS 10:
Consolidated FS

**IFRS 9: Financial
Instruments**

IFRS 13: Fair
Value Measurement

IFRS 12:
Disclosure of
Interests in Other
Entities

What is IFRS 9 *Financial Instruments*?

IFRS 9 sets out new accounting requirements for recognising and measuring financial assets and liabilities. It replaces the existing IAS 39 Financial Instruments: Recognition and Measurement.

IAS 39 – ‘too little too late’

The current IAS 39 accounting standards are widely thought to have deficiencies that contributed to the magnitude of the recent financial crisis. IAS 39 uses an incurred loss approach for financial assets, where loss is only recognised when a trigger event occurs.



IAS 39 – ‘too little too late’-cont'd

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have revised accounting standards as a result.

International Financial Reporting Standards

- In July 2014 the IASB issued the completed IFRS 9 standards, based on three phases of work which we will summarise on the next slide

FASB convergence

- The FASB has not converged with the IASB approach and is still deliberating its method of credit loss measurement

The deadline for IFRS 9 compliance and implementation is 1 January 2018

What is IFRS 9?



In July 2014 the IASB issued the new, completed IFRS 9 standards, based on three phases of work:

Part 1: Classification and measurement

- Three classification of financial assets based on business model and contractual cash flow characteristics.
- FVO financial liabilities – Change in own credit risk is presented in OCI.

What is IFRS 9?-cont'd



Part 2: Expected credit losses

- Concept of ‘expected credit loss’ measured as either:
 - 12-month expected credit losses; or
 - Lifetime expected credit losses.

What is IFRS 9?-cont'd



Part 3:Hedge accounting

- Hedge accounting is aligned more closely with risk management.
- New qualifying hedge items and hedging instruments.

What is IFRS 9?-cont'd



The impact of IFRS 9 is wide ranging:

- Fundamental re-shaping of the balance sheet and potentially the earnings profile.
- Critical to identify and address links between IFRS changes and other regulatory changes (e.g. Basel III).
- More than just an accounting change. Systems and processes will also change.

Overview – IFRS 9 Key concepts



Classification
&
Measurement



Business model
test

SPPI test

Overview – IFRS 9 Key concepts (Cont'd)



Classification
&
Measurement



Business model
test

A business model test is required to determine whether an entity's strategy for an asset is: held to collect; held to collect and sell; or held for sale.

Overview – IFRS 9 Key concepts (Cont'd)

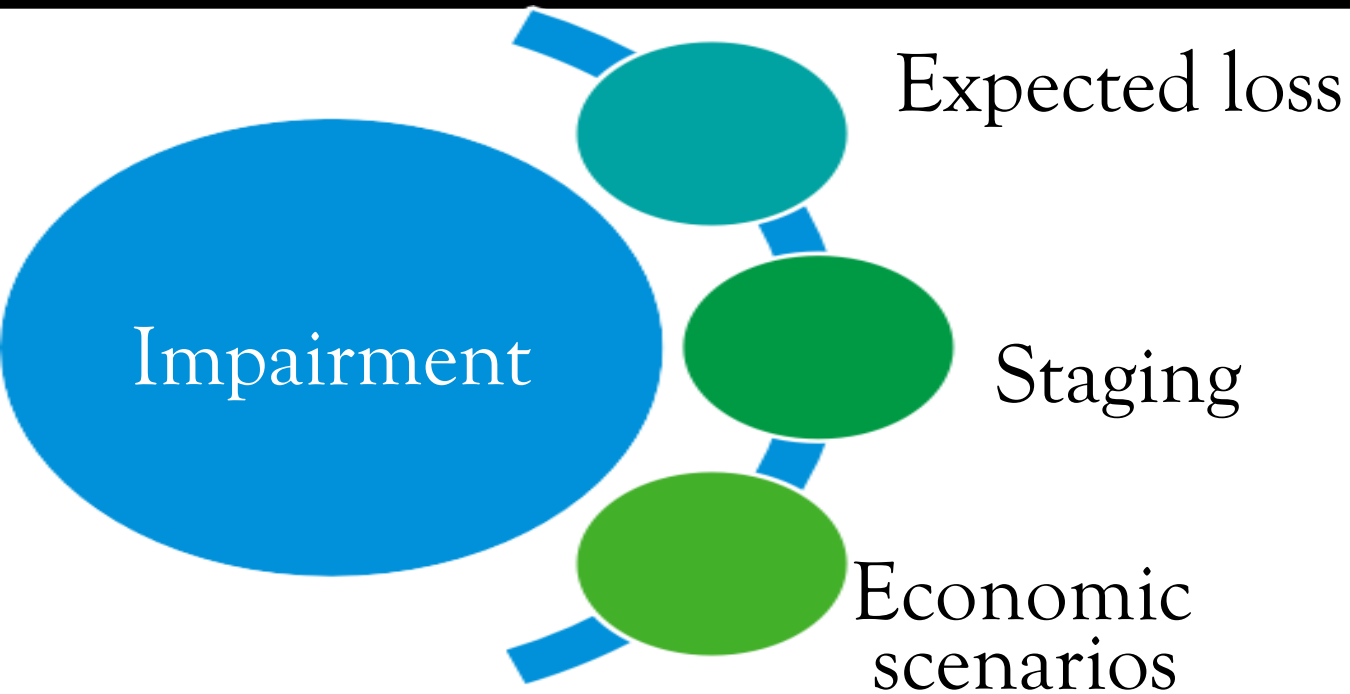


Classification
&
Measurement

 SPPI test

A “SPPI test” is applied in order to determine whether the financial asset gives rise to cash flows that are solely payments of principal and interest. If it meets this criterion, the asset may be measured at either amortised cost or FVOCI. A financial asset that does not meet the SPPI criterion is always measured at FVTPL.

Overview – IFRS 9 Key concepts (Cont'd)



Overview – IFRS 9 Key concepts (Cont'd)



Impairment



Expected loss

IFRS 9 incorporates an “expected” credit loss approach whereas IAS 39 was an “incurred” loss approach. Under the IFRS 9 approach, it is not necessary for a loss event to occur before an impairment loss is recognised. Expected credit losses are the present value of all cash shortfalls over the expected life of the financial instrument.

Overview – IFRS 9 Key concepts (Cont'd)



Impairment



Staging

The model uses a dual measurement approach, under which the loss allowance is measured as either:

- 12-month expected credit losses; or
- lifetime expected credit losses.

Overview – IFRS 9 Key concepts (Cont'd)



Impairment



Economic scenarios

Impairment models now need to take into consideration forward looking economic variables based unbiased scenarios.

Introduction to IFRS 9– Questions



How will IFRS 9
reshape the balance
sheet and earnings?

What do you expect
the Company will have
to prioritise?

Where may governance and
risk management
requirements change?

Which internal
stakeholders will be
affected?



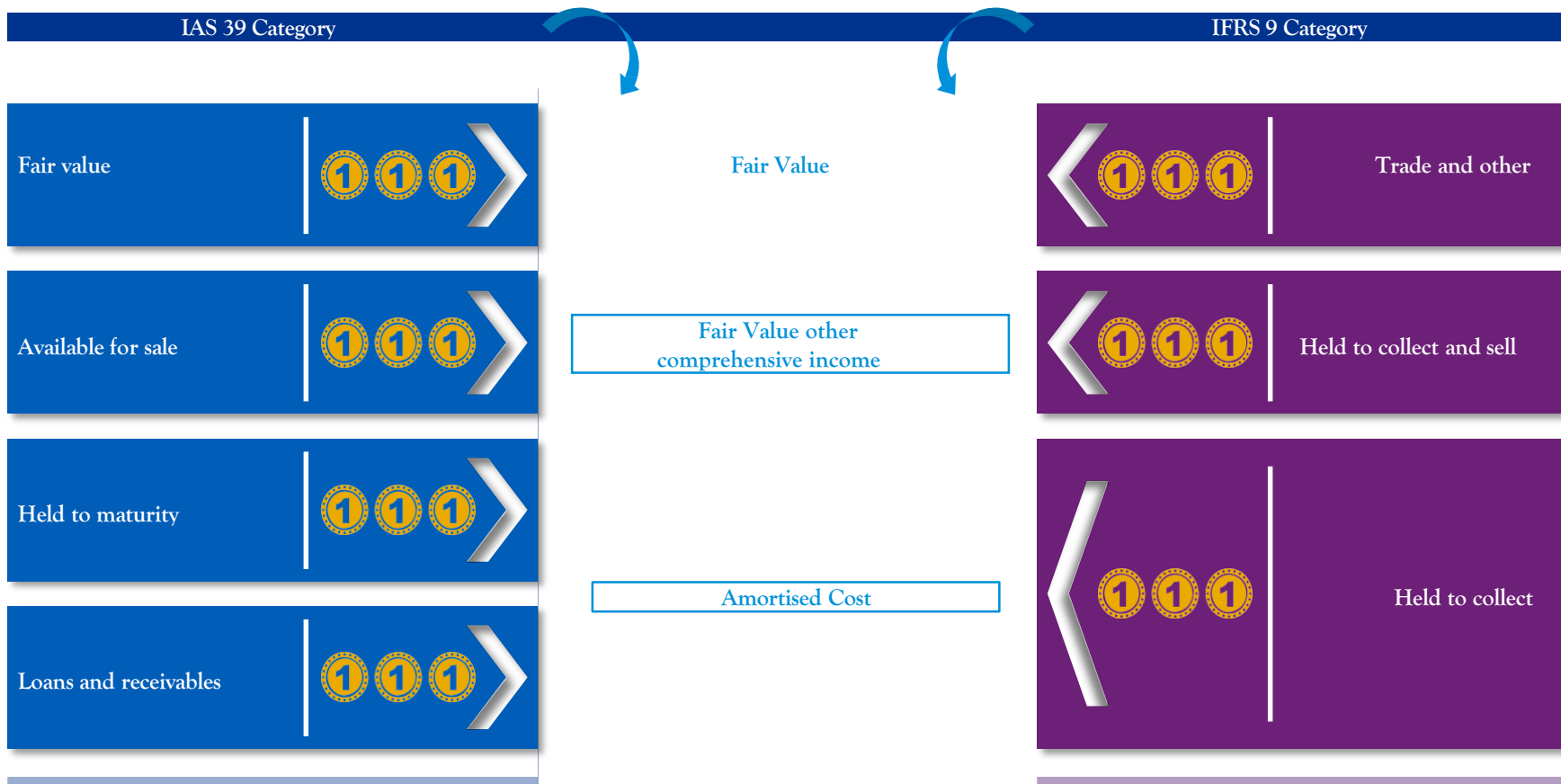
Classification and measurement

IAS 39 versus IFRS 9



IFRS 9 has changed the classification and measurement categories for financial assets that existed under IAS 39; it retains almost all of the existing requirements from IAS 39 on the classification of financial liabilities.

IAS 39 versus IFRS 9-Cont'd



Classification and measurement- overview



IFRS 9 introduced a two-step approach to determine the classification of financial assets:

1. Business model assessment; and
2. Solely payments of principal and interest ('SPPI') assessment.

Classification and measurement- overview (Cont'd)



Business model

- Considers how financial assets are managed to generate cash flows.
- Assessed at portfolio level (not instrument level).
- Sub-division of portfolios may be appropriate.

Classification and measurement- overview (Cont'd)



Business model

Examples of key challenges:

- Assessment of impact of sales activity
- Data needed for analysis of historical sales
- Prospective view
- Securitisation activities

Classification and measurement- overview (Cont'd)



SPPI

- Considers whether contractual cash flows are consistent with a basic lending arrangement.
- Principal = initial fair value of financial asset.
- Interest = consideration for time value of money and credit risk.

Classification and measurement-overview (Cont'd)

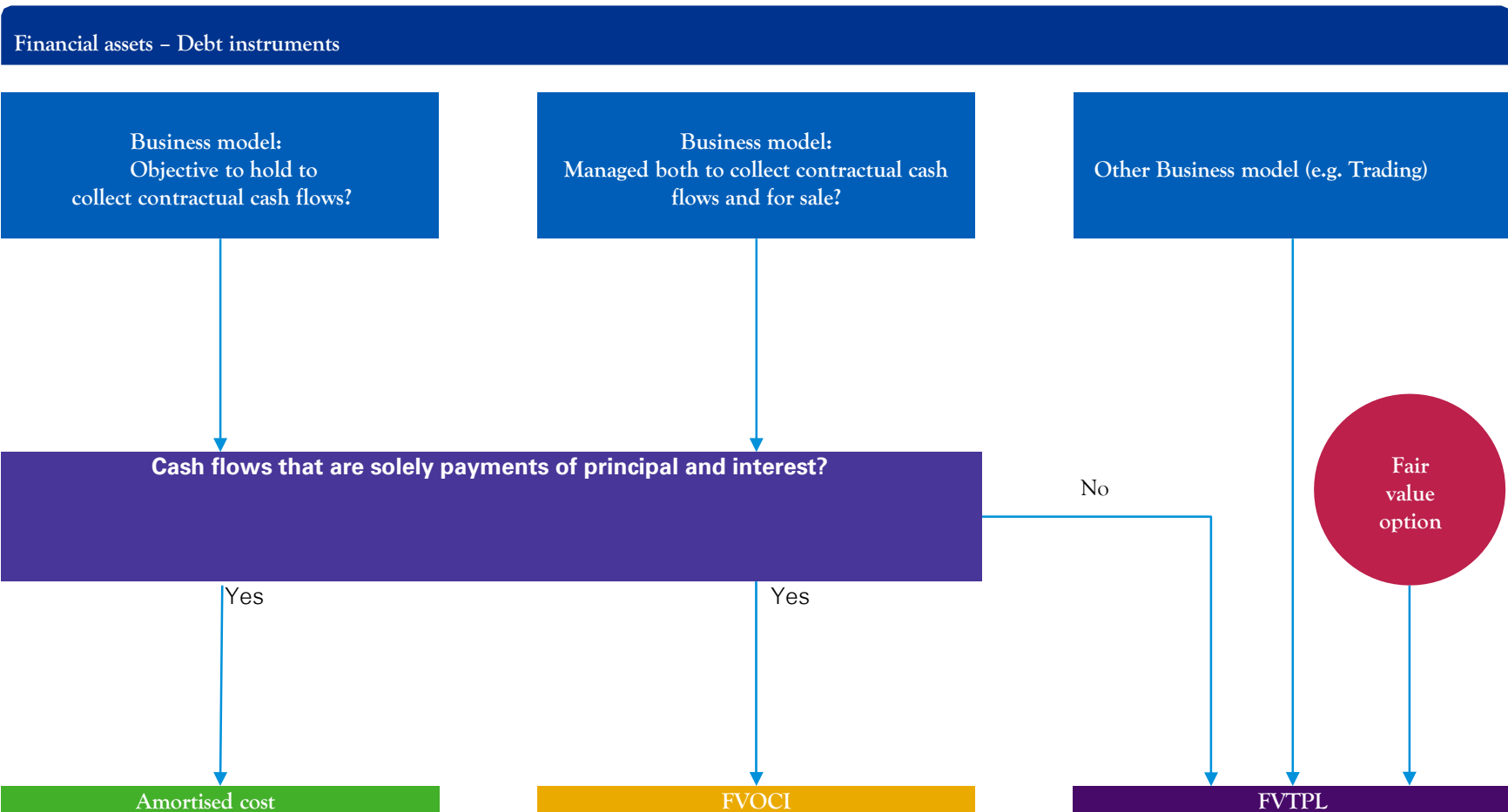


SPPI

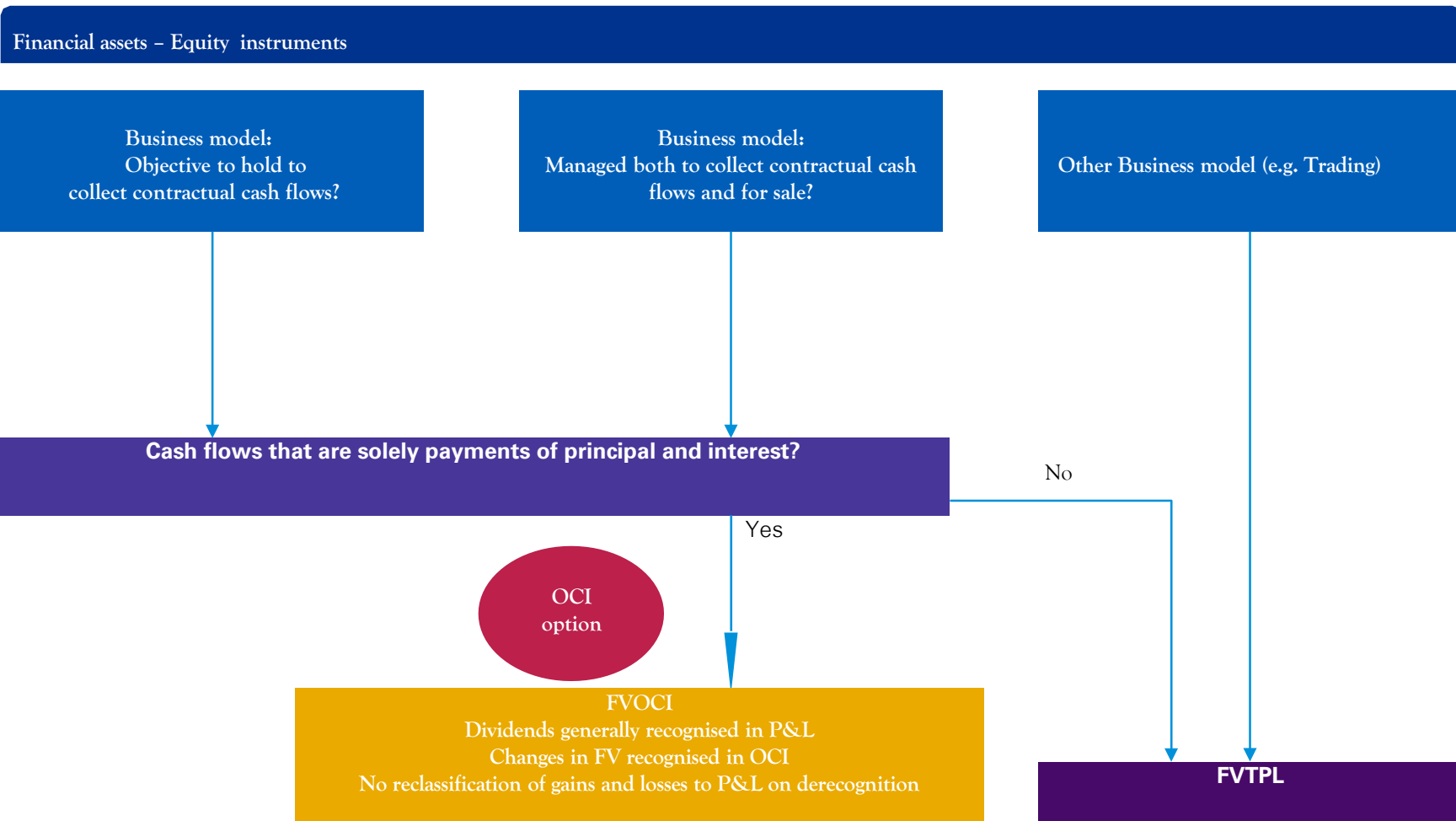
Judgemental aspects:

- Prepayment/extension options.
- Leverage.
- Contractually linked instruments.
- Hybrid instruments.

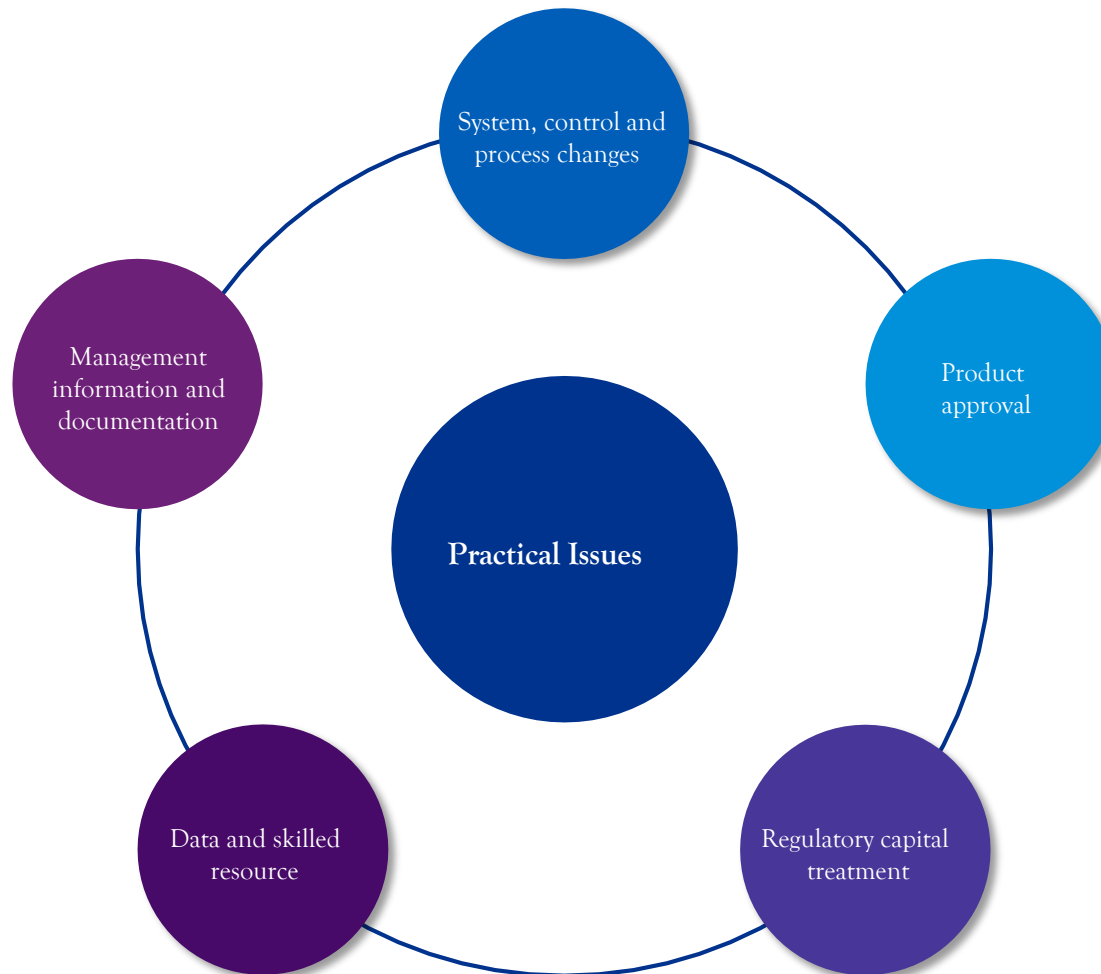
Classification and measurement- overview (Cont'd)



Classification and measurement-overview (Cont'd)



Classification and measurement- Practical issues



Classification and measurement- Questions

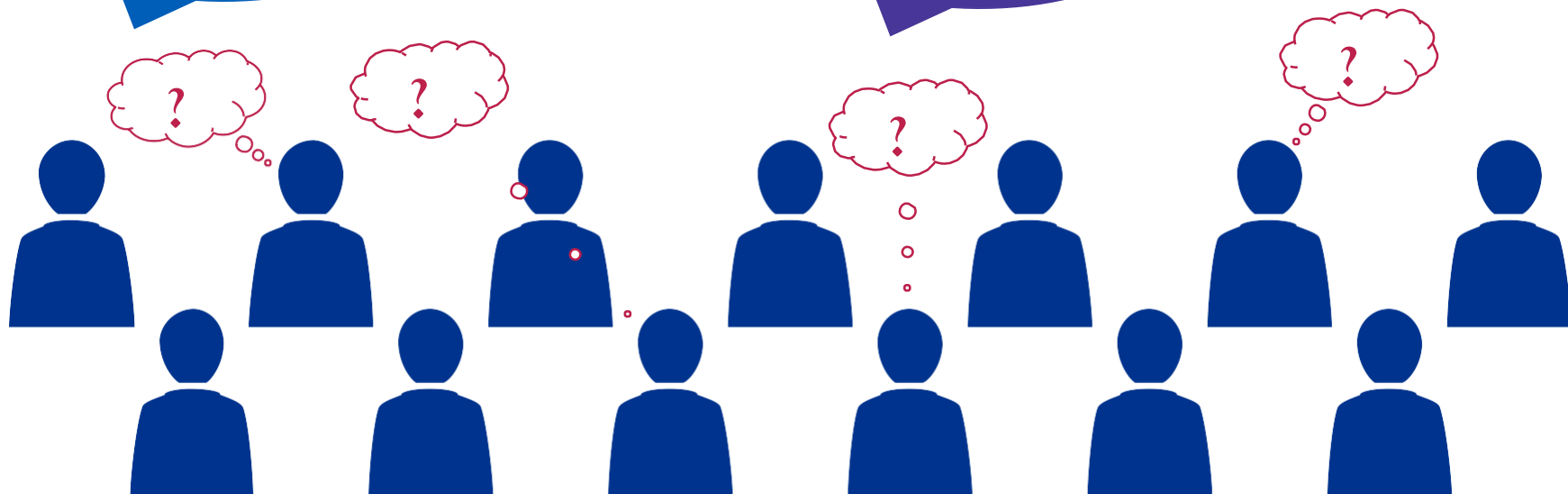


Does your Company
currently capture the data it
will need for IFRS 9?

Which portfolios will

How will the product
approval process change?

How will you govern
SPPI judgements?



Impairment

Impairment-IAS 39 versus IFRS 9



IAS 39

Collective provision (Incurred but not reported)



Specific provision (objective evidence of impairment)

IFRS 9

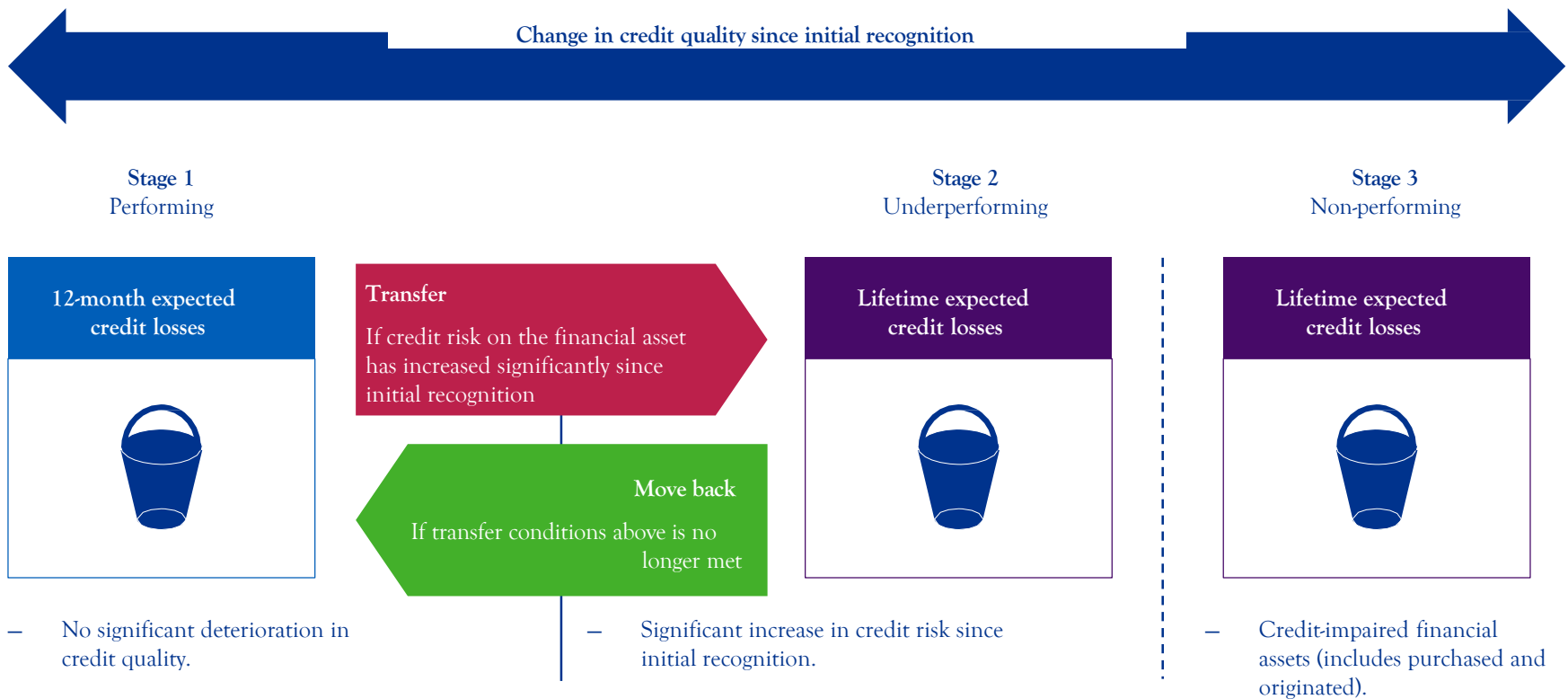
Stage 1
12 month Expected credit losses (ECL)

Stage 2 & 3
Lifetime ECL

Impairment-Expected credit loss: Approach



Scope: the impairment requirements of IFRS 9 only apply to assets classified as amortised cost or FVOCI (Fair Value Through Other Comprehensive Income).



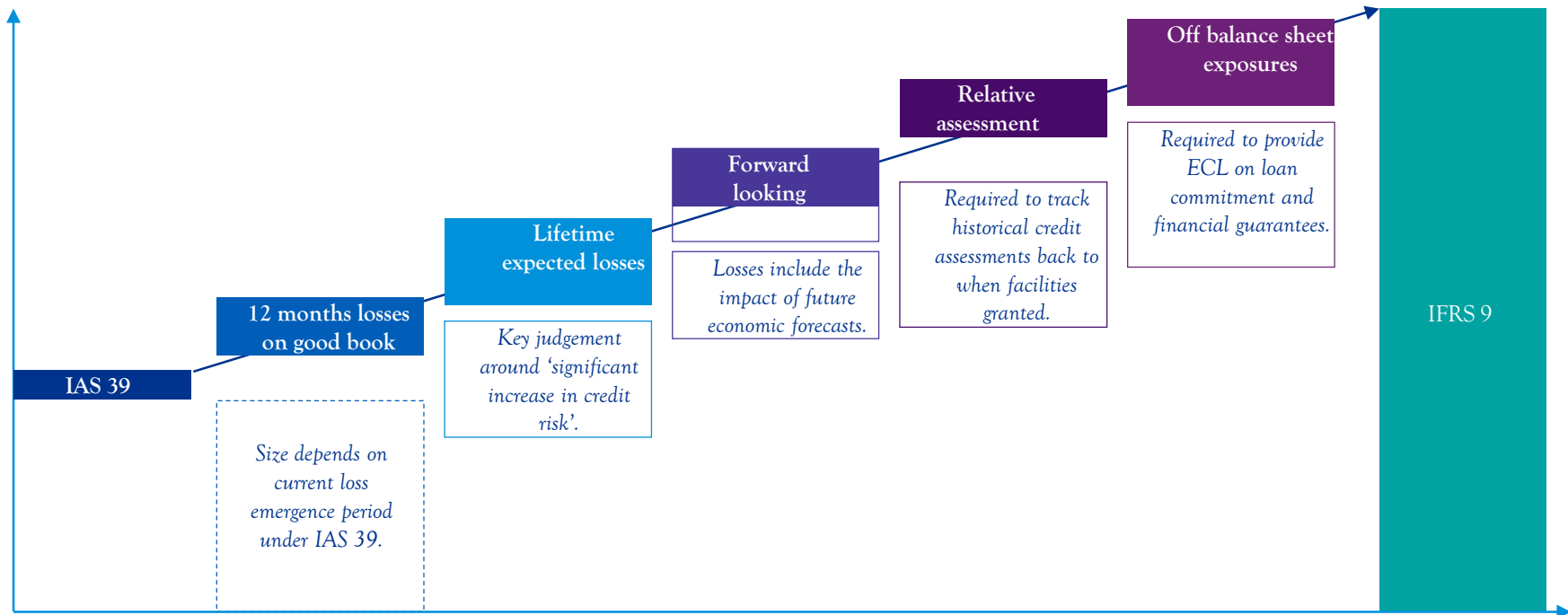
Impairment-Expected credit loss: calculation



IAS 39 prescribes an incurred loss impairment approach – after the financial crisis, this was criticised for recognising losses too late. IFRS 9 considers expected future credit losses (ECL).

ECL	PD		EAD		LGD
=		X		X	
Expected credit loss (ECL)	Probability of default (PD)		Exposure at default (EAD)		Loss given default (LGD)
	<p>IFRS 9 requires lifetime PDs to be estimated for LEL.</p> <p>Point-in-time and reflect future economic expectations.</p> <p>Risk neutral not conservative.</p> <p>Based on broader definition of default than just delinquency (e.g. includes forbearance and other unlikelihood to pay indicators)</p>	X	<p>EAD would have to be estimated over the life of the loan.</p> <p>Risk neutral not conservative.</p>	X	<p>IFRS 9 requires lifetime LGDs to be estimated for LEL.</p> <p>Point-in-time and reflect future economic expectations.</p> <p>Risk neutral not conservative.</p> <p>Includes future estimates of collateral values and redefaults.</p> <p>Discounted back to balance sheet date using the EIR.</p>
	X		X		X
	Economic scenario adjustment		Economic scenario adjustment		Economic scenario adjustment

Impairment-Effects of transition from IAS 39 incurred loss to IFRS 9 ECL



Key effects

- Increase in number and complexity of judgements:
 - What is a 'significant' increase in credit risk?
- Operationalising proposals may be challenging (e.g. resources).
- Key performance indicators may be significantly affected.

Bottom line

- Credit risk is at the heart of a society's business: Proposals likely to have big impact on building societies.
- Potential impact on profit or loss volatility.
- Implementation will be challenging.

Impairment-Key concepts supporting the three bucket approach



Scope

Under IFRS 9, a single set of impairment requirements applies to all instruments in the scope of IFRS 9 that are not accounted for at FVTPL. This may simplify the requirements and align them more closely with the way societies manage their credit risk.

Impairment-Key concepts supporting the three bucket approach (Cont'd)



Significant increase in credit risk

IFRS 9 explains that, in evaluating whether an increase in credit risk is significant, an entity compares the risk of default at initial recognition of an instrument with the risk of default at the reporting date.

Impairment-Key concepts supporting the three bucket approach (Cont'd)



Significant
increase in
credit risk

In assessing whether credit risk has increased significantly, an entity uses the change in the risk of default occurring over the expected life of the financial instrument, rather than changes in the magnitude of loss if the default were to occur.

Impairment-Key concepts supporting the three bucket approach (Cont'd)



Significant
increase in
credit risk

Therefore, changes in loss given default (LGD) are not considered for this purpose, although they are incorporated in the resulting measurement of expected credit losses (ECL).

Impairment-Key concepts supporting the three bucket approach (Cont'd)



12
month
expected
credit
losses

12-month expected credit losses' are defined as: 'the portion of lifetime expected credit losses that represents the expected credit losses that result from default events on the financial instrument that are possible within the 12 months after the reporting date.'

Impairment-Key concepts supporting the three bucket approach (Cont'd)



12
month
expected
credit
losses

This means that 12-month expected credit losses are all cash shortfalls that will result if a default occurs in the 12 months after the reporting date.

Impairment-Key concepts supporting the three bucket approach (Cont'd)



Definition of default

IFRS 9 does not define the term 'default', but instead requires each entity to do so. The definition has to be consistent with that used for internal credit risk management purposes for the relevant financial instrument, and has to consider qualitative indicators – e.g. breaches of covenants – When appropriate

Impairment-Key concepts supporting the three bucket approach (Cont'd)



Definition of default

The standard contains a rebuttable presumption that default does not occur later than 90 days past due.

Impairment-Transfer criteria



How entities define the criteria for moving financial assets between the stages for purposes of calculating expected credit losses is a key challenge of IFRS 9.

Firms are taking different approaches to determine the quantitative and qualitative ways in which they would approach significant credit deterioration.

Transfer criteria considerations include:

01

Significant deterioration

02

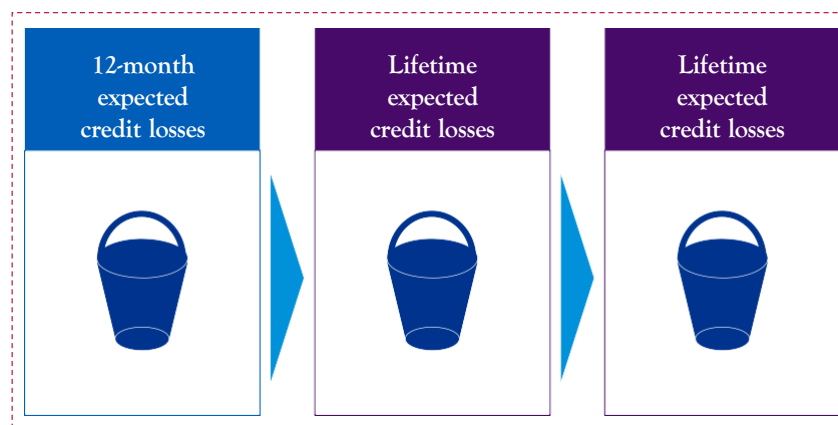
Low credit risk threshold

03

90 days past due rebuttable presumption of default

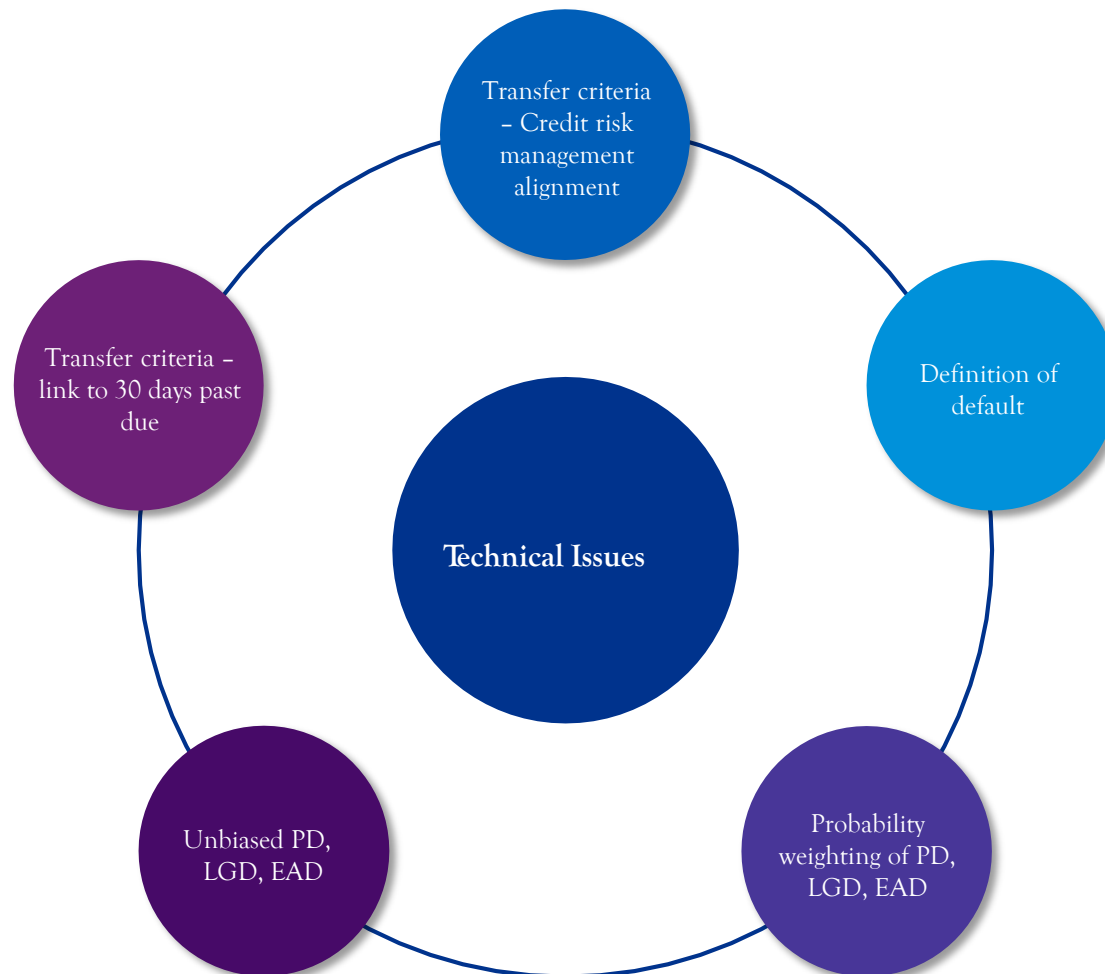
04

Establish criteria for curing and exit



One of the main criticisms of IAS 39 was 'too little, too late'. Under IFRS9, if the transfer criteria does not transit exposures into stage 2 ahead of default then the objective of the standard is not met.

Impairment-Technical issues



Impairment-Questions

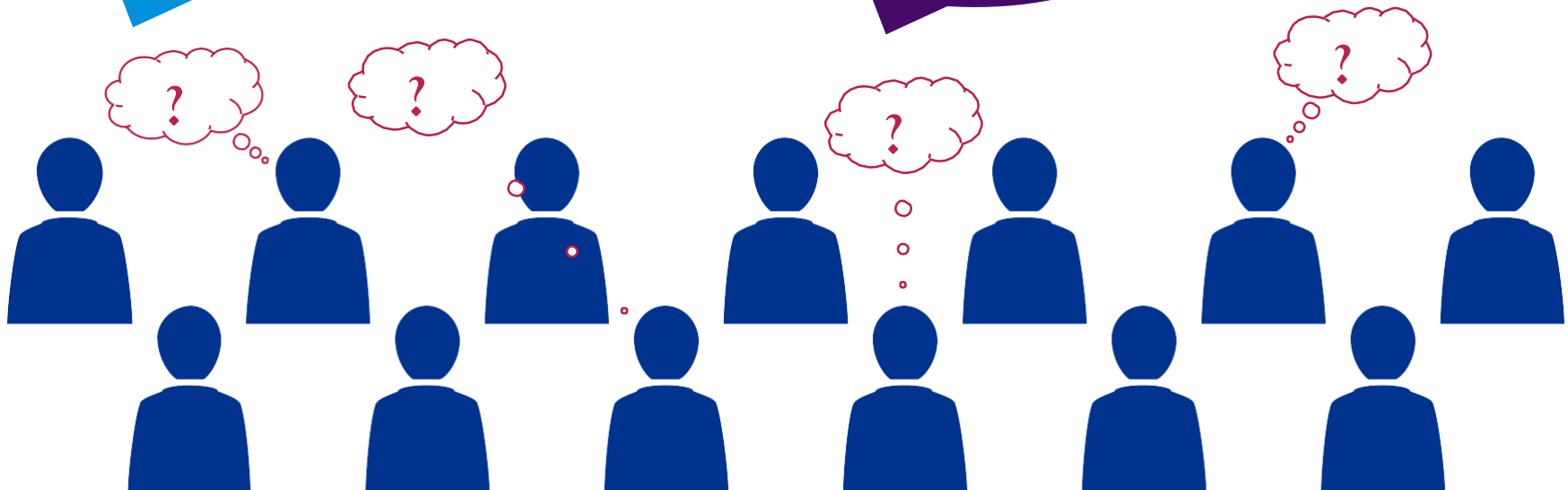


What are the potential constraints in current models/systems?

How will you source forward looking economic data?

Which products or asset classes will be most affected?

What difficulties will there be in defining transfer criteria?



IFRS 16 –Leases

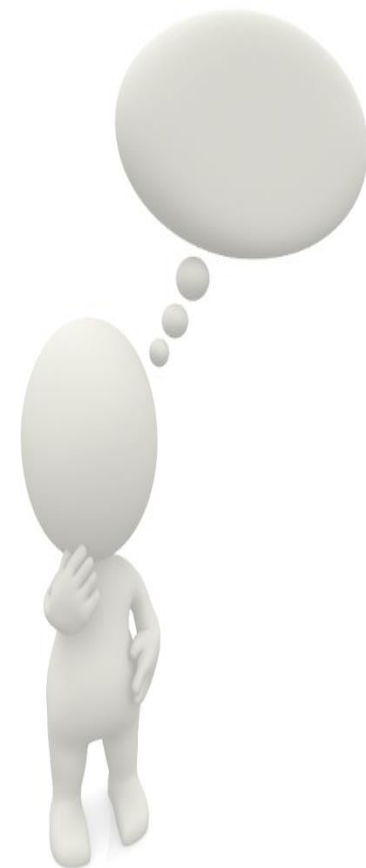


A more transparent balance sheet

Why is this important?



- Most companies lease assets.
- Under IFRS 16, lessees will bring all leases on balance sheet.
- New lease definition becomes the new on/off-balance sheet test.
- Changes many financial ratios.
- Your stakeholders/investors will want to understand the impact on your business.



Presentation agenda



IFRS 16, Leases

- ☐ Purpose and Objectives
- ☐ Why the Standard is Important
- ☐ Major impacts for lessees
- ☐ New definition, new accounting
- ☐ Next steps
- ☐ Key points to remember

More transparent lease accounting



- “IFRS 16 will bring most leases on-balance sheet from 2019. All companies that lease assets for use in their business will see an increase in reported assets and liabilities.



**Kimber Bascom,
KPMG’s global
IFRS leasing
standards leader**

More transparent lease accounting



- “IFRS 16 will bring most leases on-balance sheet from 2019. All companies that lease assets for use in their business will see an increase in reported assets and liabilities.



**Kimber Bascom,
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What's the issue?



- Currently analysts adjust financial statements for off-balance sheet leases



What's the issue?



- Under IFRS 16, companies will bring these leases on balance sheet, using a common methodology



Major impacts for lessees

Lessees face major changes



Balance sheet

Asset

= 'Right-of-use' of underlying asset

Liability

= Obligation to make lease
payments

Lessees face major changes-Cont'd



P&L

Lease expense

Depreciation

+ Interest

= Front-loaded total lease
expense

Current Standard IAS 17 Vs IFRS 16



Currently, under IAS 17 leases are treated in one of two ways, depending on the balance of risk and reward of ownership of the underlying asset under the lease contract:

Current Standard IAS 17 Vs IFRS 16- Cont'd



Finance lease:

When substantially all the risk and reward transfers to the lessee, the present value of lease payments is recognised as a liability on the balance sheet with a corresponding asset;

Current Standard IAS 17 Vs IFRS 16- Cont'd



Operating lease:

When significant risk and reward remains with the lessor, the lessee recognises the rental or lease expense in the profit and loss account, as it falls due, with no balance sheet impact.

Current Standard IAS 17 Vs IFRS 16- Cont'd



Operating lease:

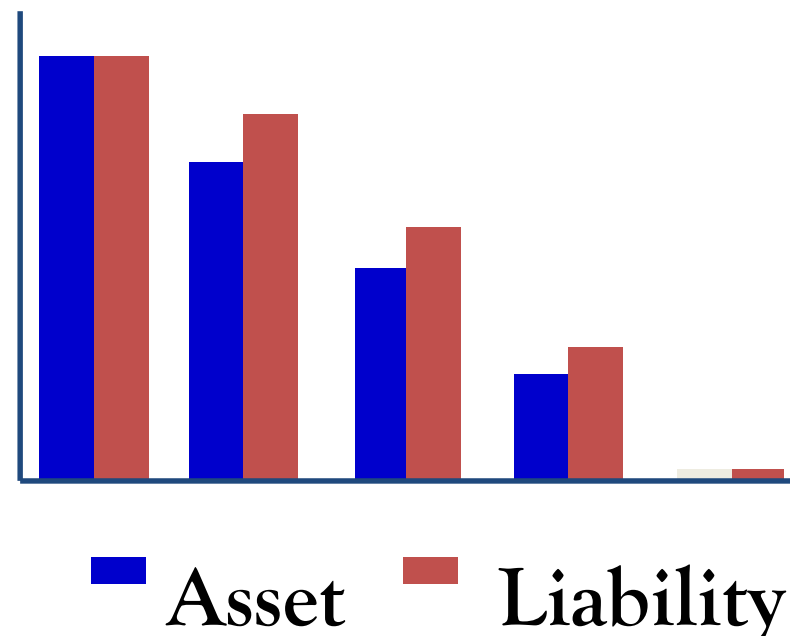
Under current practice, most non-specialised property leases are classified as operating leases, with no liability arising on the occupier's balance sheet, and only “in-year” lease costs (ie rent and service charges) are recognised in the income statement.

New Standard is effective 1 January 2019.

Impact on balance sheet



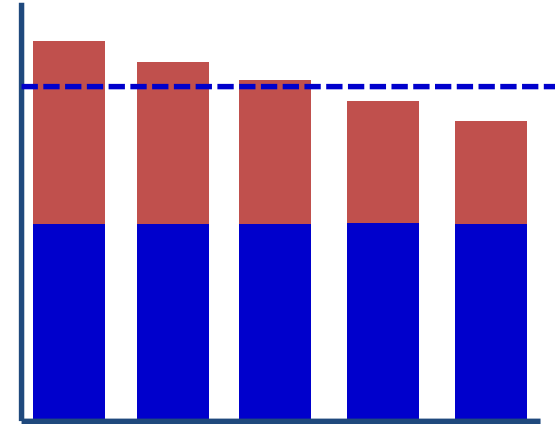
Companies with operating leases will appear to be more asset-rich, but also more heavily indebted



Impact on profit/loss





Total lease expense will be front-loaded even when cash rentals are constant



- Depreciation
- Interest
- Cash rental payments

Impact on financial ratios



	Profit/loss	Balance sheet	Ratios
	EBITDA	Total assets	Gearing
	EPS (in early years)	Net assets	Interest cover

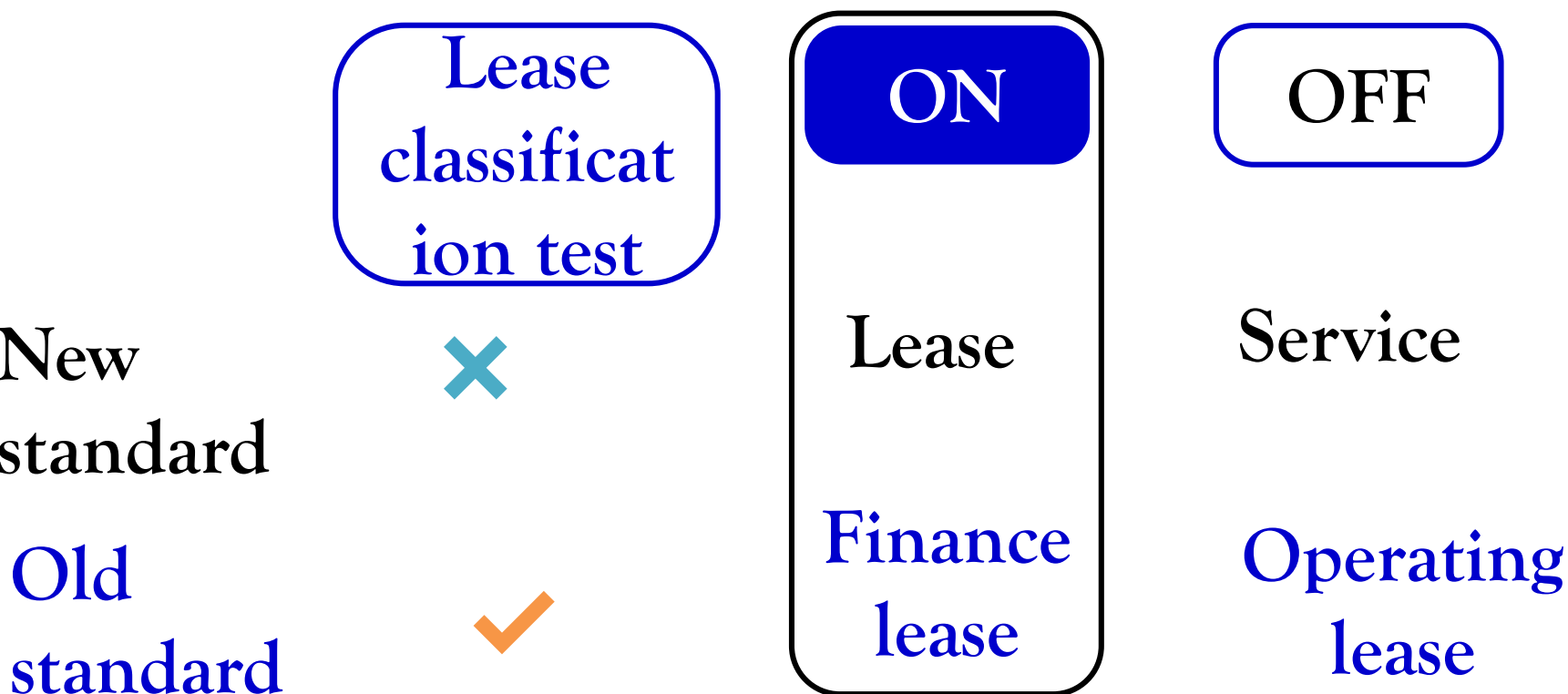


New definition,
new accounting

Lease definition



The new on/off-balance sheet test for lessees – a key judgement area



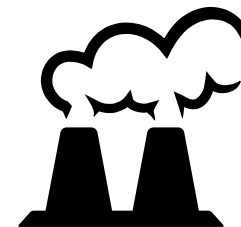
Lease definition – Control



The new definition increases focus on **who controls the asset** and may change which contracts are leases



Lease ✓



Not a lease ?

Directing the right to use



A lessee has the right to direct the use of an identified asset in either of the following situations;

- If the lessee has the right to direct how and for what purpose the asset is used throughout the period of use; or
- If the relevant decisions about how and for what purpose the asset is used are predetermined and;

Directing the right to use-Cont'd



- the lessee has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the lessor having the right to change those operating instructions; or
- the lessee designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.



Right to direct the use

Customer R enters into a contract with Company S, a ship owner, for the transport of cargo from A Coruña to Hartlepool on an identified ship. The contract details the cargo to be transported on the ship and the dates of pick-up and delivery. The cargo will occupy substantially all of the capacity of the ship. S operates and maintains the ship and is responsible for the safe passage of the cargo on board the ship. R is prohibited from hiring another operator for the ship during the term of the contract or operating the ship itself.

R does not have the right to control the use of the ship because it does not have the right to direct its use. R does not have the right to direct how and for what purpose the ship is used. How and for what purpose the ship is used – i.e. the journey from A Coruña to Hartlepool transporting specified cargo – is predetermined in the contract. R does not have the right to operate the ship and did not design the ship in a way that predetermined how and for what purpose it would be used. R has the same rights regarding the use of the ship as if it were only one of many customers transporting cargo on the ship. Therefore, the contract does not contain a lease.



Right to direct the use

Customer T enters into a five-year contract with Company U, a ship owner, for the use of an identified ship. T decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent T from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo. U operates and maintains the ship, and is responsible for safe passage.

T has the right to direct the use of the ship. The contractual restrictions are protective rights that protect U's investment in the ship and its personnel (see 3.5). In the scope of its right of use, T determines how and for what purpose the ship is used throughout the five-year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport. T has the right to change these decisions throughout the period of use. Therefore, the contract contains a lease.

Protective rights



A contract may include certain terms and conditions designed to protect the lessor's interest in the identified asset, to protect its personnel or to ensure the lessor's compliance with laws or regulations. Such protective rights typically define the scope of the lessee's right to use an asset but do not, in isolation, prevent the lessee from having the right to direct the use of the asset within that scope.

For example, a contract may:

- specify the maximum amount of use of an asset or where or when the lessee can use the asset;
- require a lessee to follow particular operating practices; or
- require a lessee to inform the supplier of changes in how an asset will be used.



Protective rights

Lessee L enters into a two-year contract with Lessor M, an aircraft owner, for the use of an identified aircraft. The contract details the interior and exterior specifications for the aircraft. There are contractual and legal restrictions in the contract on where the aircraft can fly. Subject to these restrictions, L determines where and when the aircraft will fly, and which passengers and cargo will be transported on the aircraft. M is responsible for operating the aircraft, using its own crew.

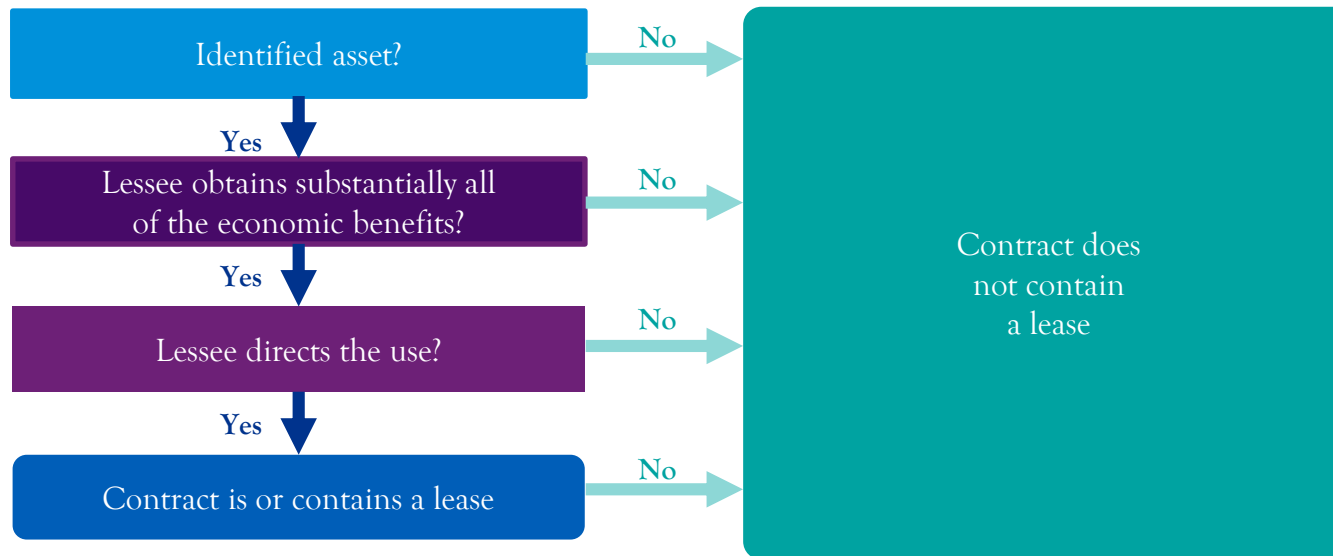
The restrictions on where the aircraft can fly define the scope of L's right to use the aircraft. In the scope of its right of use, L determines how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where and when the aircraft travels, as well as the passengers and cargo that it will transport. L has the right to change these decisions throughout the period of use.

The contractual and legal restrictions on where the aircraft can fly are protective rights and do not prevent L from having the right to direct the use of the asset.

Lease definition –overview



A lease is a contract that conveys the right to use an asset for a period of time in exchange for consideration.



Definition focuses on control over the use of an identified asset

Lease definition – Exemptions

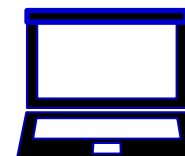


Two major
optional
exemptions make
the standard
easier to apply



Short term
leases

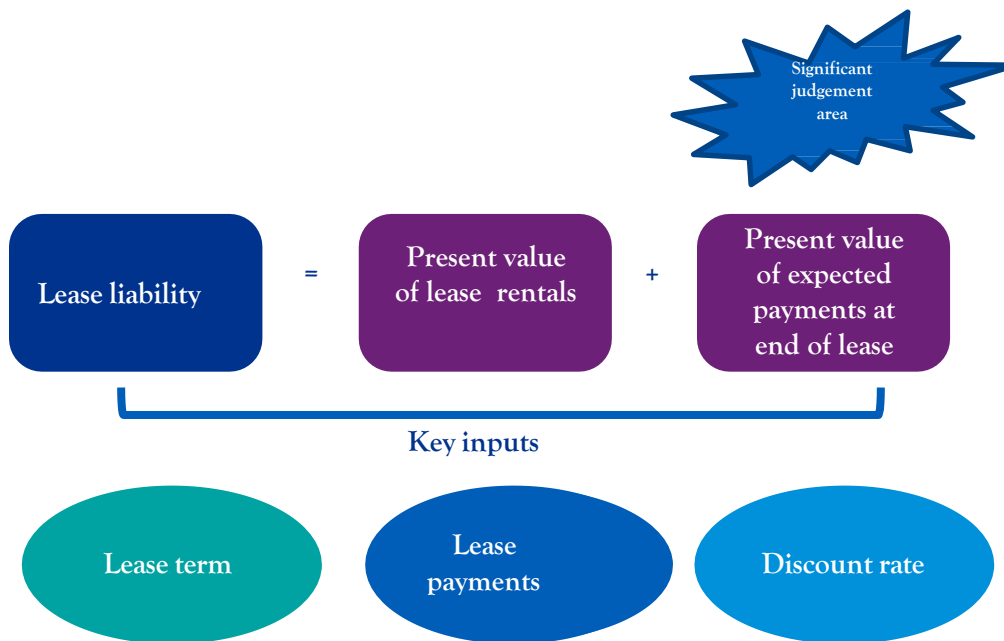
≤ 12
months



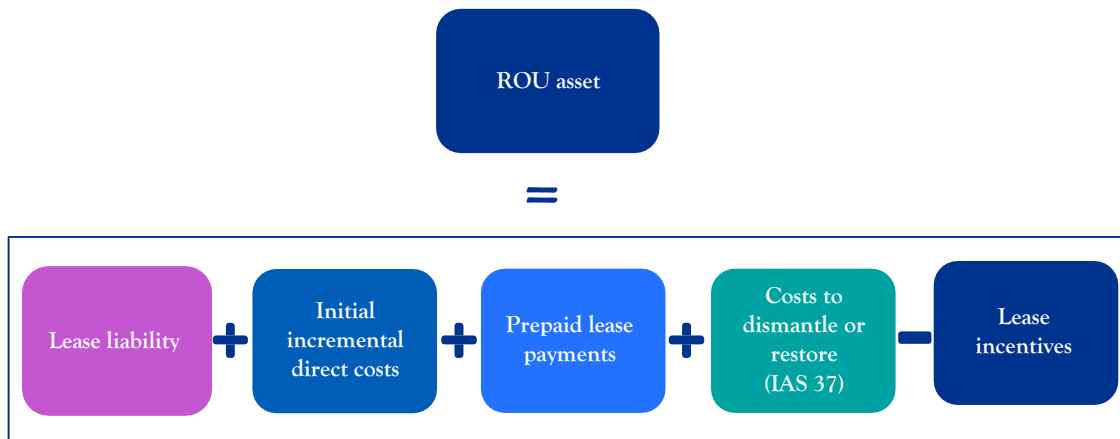
Leases of
low value
items

\leq USD
5,000
for example

Measuring the lease liability



Measuring the right-of-use (ROU) asset



Which variable lease payments are included in the lease liability?



Payments based on an index or rate



Payments based on turnover or usage

Lessor accounting



Lessor accounting remains similar to current practice...

Lease classification test



Finance leases and operating leases



but lacks consistency with new lessee accounting model

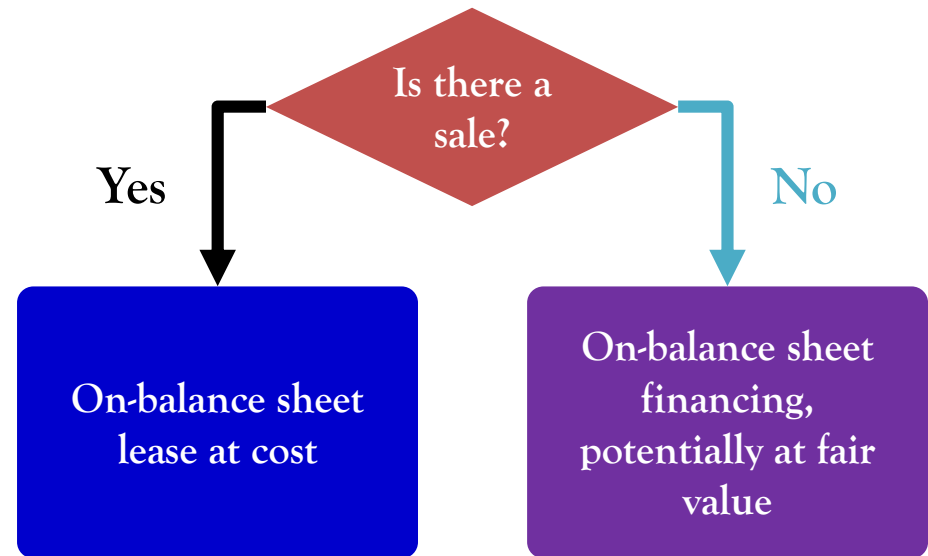
Consistent accounting model for lessors and lessees



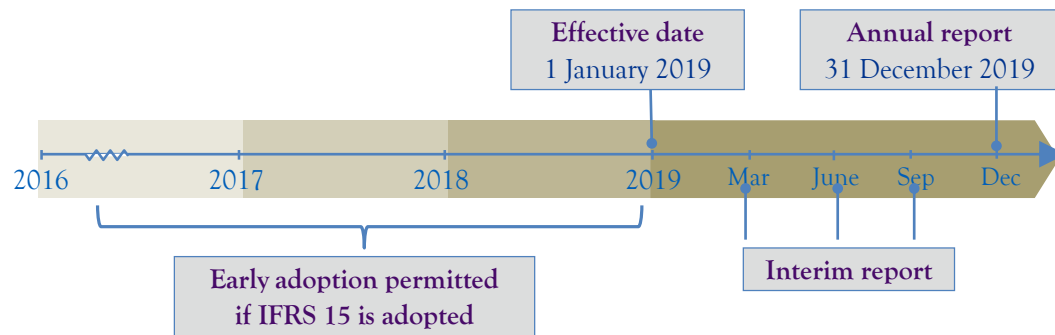
Sale and leaseback



IFRS 16 essentially **kills sale-and-leaseback** as an off-balance sheet financing structure



Effective date



Multiple transition options

Applying the new lease definition



Apply the new definition
to all contracts

Cost



Comparability



OR

Grandfather existing
contracts and apply the
new definition only to
new contracts



Applying the new standard



A lessee can choose to apply the standard...

Retrospectively to all accounting periods

OR

As a 'big bang' at the date of initial application

Cost

Comparability





Next steps

Things to think about now



Some questions to
assess the impact
on your company's
financial
statements

Which contracts are
leases?

Which transition
options to choose?

Database of all
leases?

Systems and
processes in place?

What about ratios
and covenants?



Thank you