Impact of IFRS 9 on Financial Assets and Liabilities

Presentation by:

CPA Stephen Obock

Uphold public interest

Presentation agenda

❑ **Introduction**

❑ **Classification and measurement**

❑ **Impairment**

❑ **Q&A**

Effective date

Impact assessment & Considerations:
Operating model expected loss model data/systems and controls disclosures and reporting

Issue date
24 July 2014

Effective date
1 January 2018

No requirement to restate. Restate only if no hindsight

TEST RUN

2014

2015/ 2016

2017

2018

June

Dec

Early adoption permitted

Interim reports

Annual report
31 Dec 2018

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

- Changes to categories not considered significant:

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

Significant changes in criteria for classifying assets.
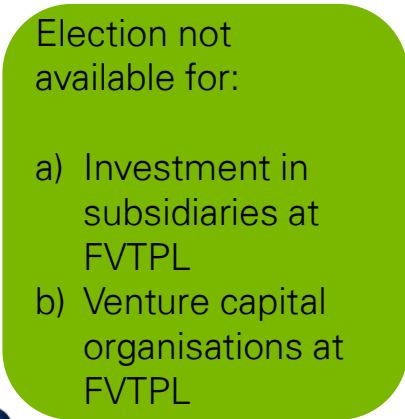
FVTPL – Fair value through profit or loss
FVOCI – Fair value through other comprehensive income
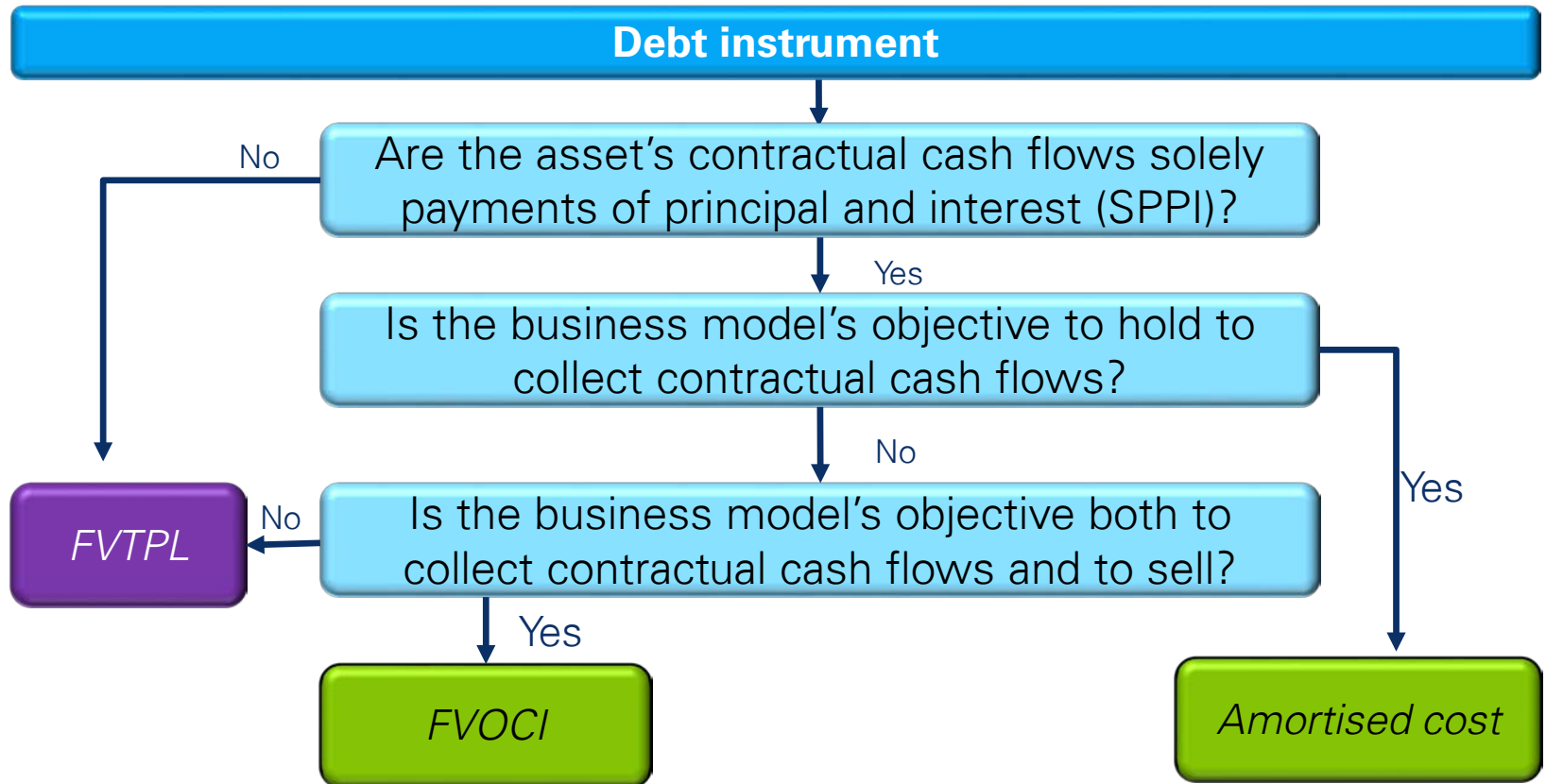HTM – Held to maturity
AFS – Available for sale

IFRS 9 – Equity and derivative financial asset classification

No separation of embedded derivatives

Derivative

Equity Instrument

Held for trading?

OCI option elected?

Yes

Yes

No

No

Yes

FVTPL

FVOCI

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

Debt instrument

Are the asset's contractual cash flows solely payments of principal and interest (SPPI)?

— No → **FVTPL**

— Yes ↓

Is the business model's objective to hold to collect contractual cash flows?

— No ↓

— Yes → **Amortised cost**

Is the business model's objective both to collect contractual cash flows and to sell?

— No → **FVTPL**

— Yes → **FVOCI**

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.

FVOCI*

— Typically involves greater frequency and value of sales compared to held to collect model.

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)

An entity has a business model with the objective of providing credit to customers and subsequently 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.

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

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) 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

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

Expected loss model = **Past events** + **Current conditions** + **Forecast of future economic conditions**

Overview - IFRS 9 Expected Credit Loss

IAS 39

Lifetime expected losses

Key judgment around 'significant increase in credit risk', definition of default

Forward looking

Losses include the impact of future economic forecasts.

Relative assessment

Required to track historical credit assessments back to when facilities granted.

Off balance sheet exposures

Required to provide ECL on loan commitments and financial guarantees

IFRS 9

Impairment - high level overview

EL = PD ˣ LGD ˣ EAD

- Expected loss is a statistical measure used to reflect expectations of future losses based on historical data. Derived based on observation, empirical evidence and expert judgment

- Probability of default for an asset or class of assets (PD) represents an average expectation over the course of an entire business cycle.

- Loss given default based on losses resulting from defaults. LGD will be separated for secured and unsecured portions of an exposure.

- Exposure at default represents the amount a financial institution stands to lose in the event of a default event

- 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

Lease Receivables

Trade receivables and contract assets with a significant financing component

Trade receivables and contract assets without a significant financing component

Policy election to apply

General Approach

12-month expected credit loss

Transfer

Move Back

Lifetime expected credit loss

Simplified Approach

Loss allowance always equal to lifetime expected credit losses
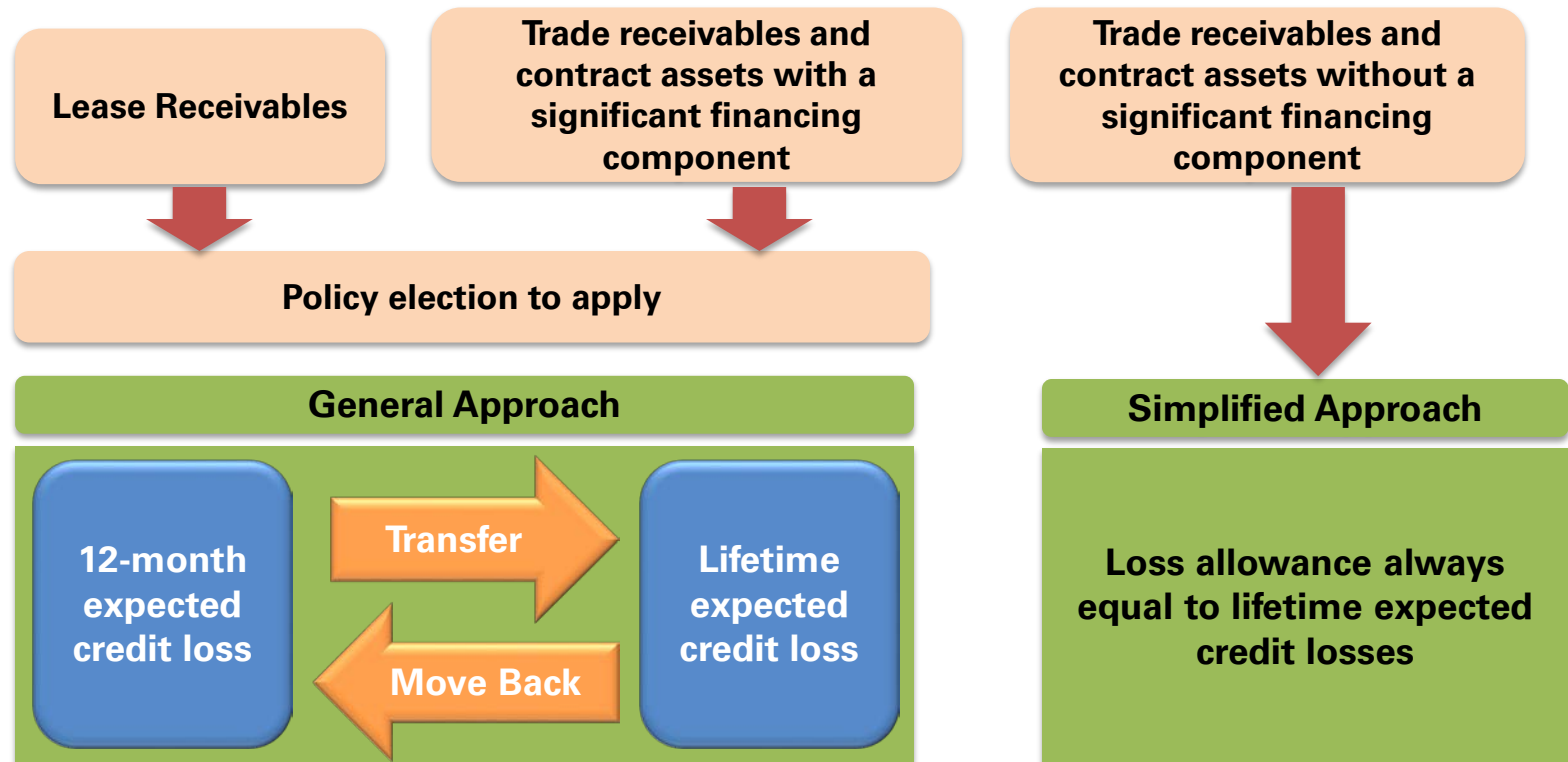
IFRS 9 ECL – General model

Significant increase in credit risk (credit deterioration) since initial recognition

Impairment recognition

| 12-month expected loss | Lifetime expected loss | Lifetime expected loss |

Interest revenue recognition

| EIR on gross amount (excl loss allowance) | EIR on gross amount (excl loss allowance) | EIR on amortised cost (net of loss allowance) |

Stage 1
Performing
"The Good"

EIR: Effective interest rate

Stage 2
Under-Performing
"The Bad"

Stage 3
Non-Performing
"The Ugly"

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

IFRS 9 provisioning for receivables

IFRS 9 includes the following simplifications for impairment of trade receivables, contract assets and lease receivables:

Situation	Proposed Approach
Trade receivables and contract assets of one year or less or those without a significant financing component.	Recognize a loss allowance at an amount equal to lifetime expected credit losses.
Trade receivables and contract assets without a significant financing component.	Simplified approach of recognizing lifetime expected loss.
Lease receivables	Accounting policy choice to measure the loss allowance at an amount equal to lifetime expected credit loss.

IFRS 9 provisioning for receivables

IFRS 9 standard does not prescribe how an entity shou~~~~~~~~~~~ lifetime expected credit losses (ECL) for receivables but proposes a provision matrix approach.

Provision Matrix -Steps

- Ageing of receivables
- Segmentation
- Development a provision matrix
- Incorporation of forward looking information.

Single loss rate approach

- Determine an average historical loss rate *(uncollected amount/total trade receivables)*
- Incorporation of forward looking information.

Provision matrix

Constructing default rates

Historical loss-rate

Adjust future expectations

Management judgement overlay

As per IFRS Paragraph(BC5.252), an entity should apply a default definition that is consistent with its credit risk management practices. The entity may have multiple definitions of default for example, for different categories of debtors.

Provision matrix/flow rate matrix approach

Step 1: Collect receivables aging and calculate the flow rate

In this step, the entity collects periodic receivables aging reports and calculates a flow /transfer rate. Flow rate represents the probability of a receivable moving into the next aging bucket in the subsequent period. This calculation is performed periodically in line with business practice.

Trade receivables aging (ETB)	Q1	Q2	Q3	Q4
0 – 30 days	20,000	19,750	23,500	21,250
31 – 60 days	10,340	9,800	8,750	10,100
61 – 90 days	5,120	4,300	3,900	4,150
91 + days	1,400	1,350	1,490	1,390

Flow rate	Q2	Q3	Q4
0 – 30 days	49%	44%	43%
31 – 60 days	42%	40%	47%
61 – 90 day	26%	35%	36%
91+ days	100%	100%	100%

Provision matrix/flow rate matrix approach

Step 2: Calculate the loss rate

A loss rate is calculated for each bucket. The calculated loss rate represents the probability that the receivables in a given bucket will reach the 91+ days category. This example assumes that the 91+ days balance is equal to the actual historical loss.

Flow rate	Q2	Q3	Q4
0 - 30 days	49%	44%	43%
31 - 60 days	42%	40%	47%
61 - 90 day	26%	35%	36%
91+ days	100%	100%	100%

Loss rate	Q2	Q3	Q4	Average
0 - 30 days	5%	6%	7%	**6%**
31 - 60 days	11%	14%	17%	**14%**
61 - 90 day	26%	35%	36%	**32%**
91+ days	100%	100%	100%	**100%**

Expected credit loss computation

Calculation of the expected credit loss

The calculation of the expected credit loss is as illustrated below using both provision matrix and single loss rate approaches:

ECL computation illustration for provision matrices approach

Financial Asset	Bucket	Historical PD	FLI Adjustment	Adjusted PD	Exposure as on 31 Dec 2017	ECL
Trade receivables	0 - 30 days	6%	(1.05%)	5.94%	2,000,000	118,800
	31 - 60 days	14%	(1.05%)	13.85%	1,000,000	138,500
	61 - 90 day	32%	(1.05%)	31.67%	300,000	95,010
	91+ days	100%	n/a	100.00%	900,000	900,000

The expected credit loss model above assumes a write-off threshold of 90 days.

Q&A