Financial Reporting Workshop

IFRS 9 & 15: Putting it into Practice

Eastern Branch – November 2019

Uphold Public Interest

Overview

- IFRS 9
  - Recap on classification
  - Simplified Approach – Provisions Matrix
  - Disclosures – case of Financial Institution

- IFRS 15
  - 5-step approach in practice
  - Disclosures – interpreting financial statement

- Entity A sold one of its diverse business operations and currently has CU10 million of cash. It has not yet found another suitable investment opportunity in which to invest those funds so it buys short dated (6 month maturity) high quality government bonds in order to generate interest income. It is **<u>not considered likely</u>** but, if a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. **Otherwise it will hold the bonds to their maturity date.**

- Question: Is the 'hold-to-collect' business model test met?

- *Example 2 – SPPI test for loan with zero interest and no fixed repayment terms*
- Parent A provides a loan to Subsidiary B. The loan is classified as a current liability in Subsidiary B's financial statements and has the following terms:
  - No interest;
  - No fixed repayment terms; and
  - Repayable on demand of Parent A.

- Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

- *Example 4 – SPPI test for a loan with interest rate cap*

- Entity B lends Entity C CU5 million for five years, subject to the following terms:
  - Interest is based on the prevailing variable market interest rate
  - Variable interest rate is capped at 8%
  - Repayable in five years.

- Question: Does the loan meet the SPPI contractual cash flows characteristic test?

- *Example 5 – SPPI test for loan with profit linked element*

- Entity D lends Entity E CU500 million for five years at an interest rates of 5%. Entity E is a property developer that will use the funds to buy a piece of land and construct residential apartments for sale. In addition to the 5% interest, Entity D will be entitled to an additional 10% of the final net profits from the project.

- Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

- *Example 6 – 'Hold-to collect' business model test for sale before maturity*

- Entity A sold one of its diverse business operations and currently has CU10 million of cash. It has not yet found another suitable investment opportunity in which to invest its funds so it buys medium dated (3 year maturity) high quality government bonds in order to generate interest income. It is considered **likely that a suitable investment opportunity will be found before the maturity date,** and in that case Entity A will sell the bonds and use the proceeds for the acquisition of a business operation. Otherwise Entity A plans to hold the bonds to their contractual maturity.

- Question: Are the criteria for a 'hold-to-collect' or 'hold-to-collect and sell' business model met?

Simplified loss rate approach

- Does not require sophisticated credit risk management systems in place.

- Lifetime ECL are calculated using a provision matrix which can be constructed using the following steps:
    1. receivables are segmented based on different credit loss patterns (e.g. based on customer type, product type, geographical region, collateral etc.);
    2. ageing of receivables is prepared;
    3. historical loss patterns are calculated and treated as a starting point is estimating loss rate;
    4. historical data is adjusted to take into **account reasonable and supportable information** that is available **without undue cost or effort** at the reporting date about **current conditions** and **forecasts of future** economic conditions

- *Example: lifetime ECL for trade receivables using a provision matrix*

- Entity A is a service provider and has 2 types of customers: individual customers (B2C) and business customers (B2B). Entity A believes that B2C / B2B segmentation best reflects credit loss patterns. Sales are usually made on credit, therefore Entity A has a significant balance of trade receivables outstanding at each reporting date, and have no significant financing component.

Key considerations

- **Determining appropriate groupings -** examine historical credit loss rates to identify if there are significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer credit rating, collateral or trade credit insurance and type of customer (such as wholesale or retail).

- **Adjusting historical loss rates for forward looking information -** consider whether application of a loss rates approach is appropriate for the portfolio and whether the calculated historical loss rates have been appropriately adjusted to reflect the expected future changes in the portfolio condition and performance based on the information available as at the reporting date.

Determine the period over which observed historical loss rates are appropriate

- There is no specific guidance in IFRS 9 on how far back the historical data should be collected.

- Judgment is needed to determine the period over which reliable historical data can be obtained that is relevant to the future period over which the trade receivables will be collected.

- In general, the period should be reasonable – not an unrealistically short or long period of time. *In practice, the period could span two to five years.*

Determine the total credit sales and total credit loss over the selected historical period

- Identify the total credit sales made and the total credit losses suffered on those sales. The data captured over the relevant period should be combined and averages should be calculated. *For simplicity the example used reflects information obtained for one financial year.*

- Assuming the cosmetic company used the data from its sales in January 2018, it determined the following:
  - Total credit sales recorded in January 2018: 100,000
  - Total credit losses relating to those sales: 2,000

- Analyse data to determine how long it took for it to collect all of its receivables (i.e. migration of balances through the ageing bands) and to determine the proportion of balances in each past-due category that was ultimately not received.

Provision Matrix

	Amounts Paid	Receivables outstanding	Receivables ageing	Loss rate
sales in January		100,000	not overdue	2%
paid on time	50,000	50,000	overdue 1-30 days	4%
paid 1-30 days after due date	27,000	23,000	overdue 31-60 days	9%
paid 31-60 days after due date	15,000	8,000	overdue 61-90 days	25%
paid 61-90 days after due date	6,000	2,000	overdue 91+ days (not paid at all)	100%

Consider forward looking macro-economic factors and conclude on appropriate loss rates

- The historical loss rates calculated above reflect the economic conditions in place during the period to which the historical data relates – 2018 financial information.

- Assuming at the 2019 reporting date information was available that in one specific geographical region unemployment was expected to rise because of a sudden economic downturn and that increase in unemployment [20%] was expected to result in increases in defaults in the short term – how do we factor this so that the historical loss rates reflect the appropriate expected losses?

- In this will be an area of significant judgement and will be a function of reasonable and supportable forecasts of future economic conditions.

Provision Matrix (continued)

Amount	Ageing (days)	Loss rate	Adjusted* loss rate	EC* allowance	EC allowance
	total ECL allowance			33,300.00	*27,567*
300,000	not overdue	2%	2%	7,200.00	*6,000*
140,000	overdue 1-30	4%	4.8%	6,720.00	*5,600*
60,000	overdue 31-60	9%	10.8%	6,480.00	*5,217*
23,000	overdue 61-90	25%	30.0%	6,900.00	*5,750*
5,000	overdue 91+	100%	120.0%	6,000.00	*5,000*

*Adjusted to reflect forecast

- **IFRS 15 Group discussion**
  - Refer Group discussion document

Thank you
for
listening!