Financial Reporting Workshop

IFRS 9 & 7: Financial Instruments & Disclosures/Prudential Guidelines

Eastern Branch – November 2019

Outline

- Introduction
- IFRS 9
  - Classification, Measurement & Recognition
  - Impairment – an overview
- Disclosures (IFRS 7)
- Taking stock – after 1 year of implementation?
- Way forward….

Introduction

- A **Financial Instrument** is **any contract** that gives rise to both a **financial asset** of one entity and a **financial liability** or **equity instrument** of another entity;

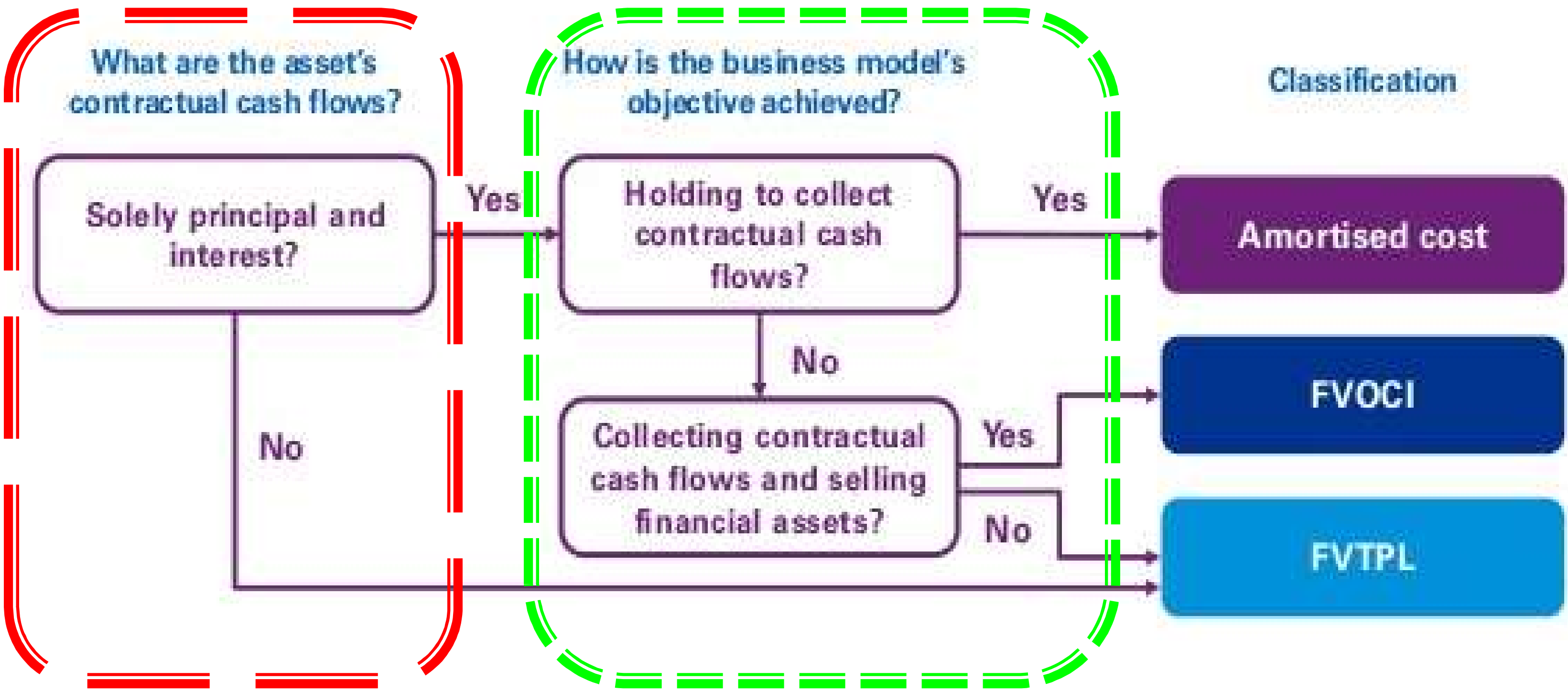
- A financial asset is any asset that is
  - cash,
  - a contractual right to receive cash or another asset; or
  - To exchange financial assets or liabilities under potentially favourable conditions; or
  - An equity instrument of another entity.

Introduction

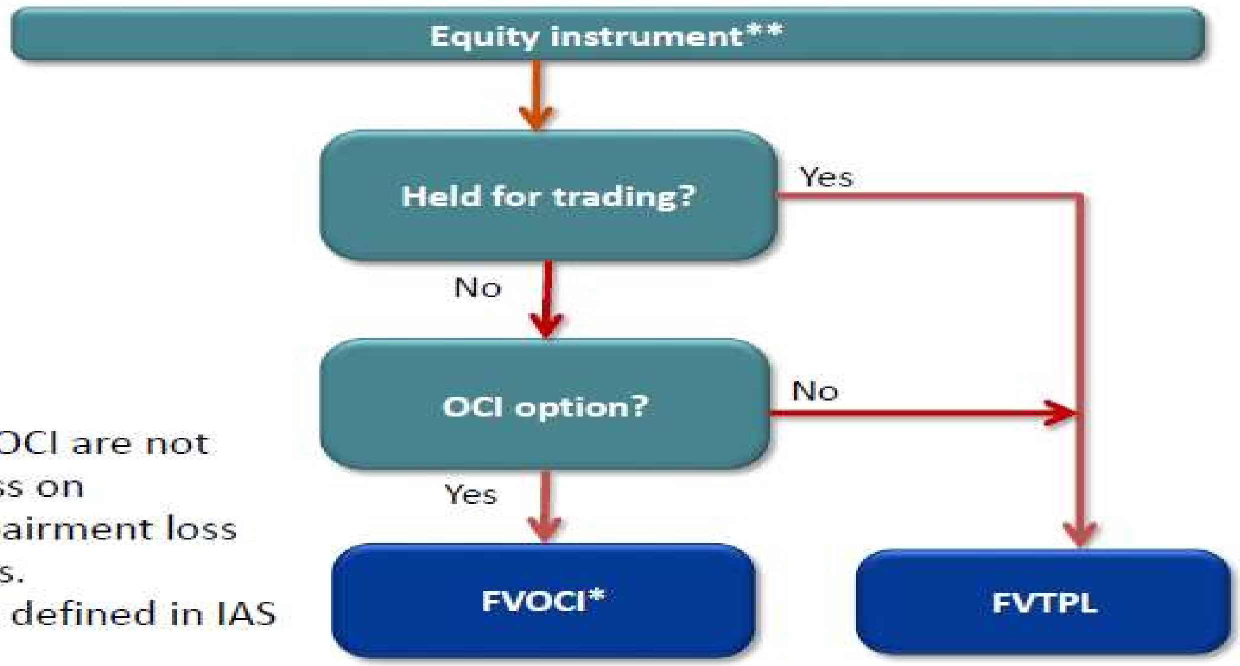
- **Financial liability** is a contractual obligation;
  - To deliver cash or another financial asset to another entity; or
  - To exchange financial instruments under **potentially unfavourable** conditions; or
  - A contract that will or may be settled in the entity's own equity instrument.....

- An **equity instrument** is any contract that evidences the **residual interest** in the assets of an entity after deducting all its liabilities

Classification – Debt instrument



Classification – Equity Instrument



* Amounts recognised in OCI are not reclassified to profit or loss on derecognition and no impairment loss recognised in profit or loss.
** Equity instrument is as defined in IAS 32

Business Model

- **'Hold-to-collect'** business model - The entity's objective is to **hold the financial asset to collect the contractual cash flows** from the financial asset **rather than** with a view to **selling** the asset to realise a profit or loss.

- **Examples**
  - Trade receivables
  - Loan receivables with 'basic' features
  - Investments in government bonds that are not held for trading
  - Investments in term deposits at standard interest rates.

- *The 'hold-to-collect' business model does not require that financial assets are always held until their maturity. Questions to ask?*
  1. *the reason(s) for the sales, and*
  2. *the expected frequency of sales*

Business Model (continued)

- **'Hold-to-collect and sell'** business model – The entity's objective is achieved by **both** **holding** the financial asset in order to collect contractual cash flows and **selling** the financial asset = FVOCI
- Examples - Investments in government/corporate bonds where the investment period is likely to be shorter than maturity.
- *The following would **not be consistent** with the **'hold-to-collect'**:*
  - *objective for managing the debt investments is to realise cash flows through sale; or*
  - *performance of the debt investment is evaluated on a fair value basis.*

Cash Flow Characteristics

- Contractual cash flows are considered to be SPPI if the contractual terms of the financial asset only give rise to cash flows that are **solely payments of principal and interest** on the principal amount outstanding on specified dates i.e. the **contractual cash flows are consistent with a basic lending arrangement** (*time value of money and credit risk-interest*).

- However, if the contractual cash flows are linked to features such as **changes in equity or commodity prices**, they would not pass the SPPI test because they introduce **exposure to risks or volatility that are unrelated to a basic lending arrangement.**

Classify the following Financial Instruments

1. Bank deposits repayable on demand, where interest, if payable, is at a fixed or floating market rate;
2. Investments in shares where the holder does not designate the asset as FVOCI;
3. Trade receivables requiring payment only of fixed amounts on fixed dates;
4. Term loans or investments in debt securities that require only fixed payments on fixed dates;
5. Self-standing derivative financial assets such as purchased options, swaps and forward contracts;
6. Fixed or floating rate loans including terms where payments are based on factors such as equity or commodity prices, unless the terms are not genuine or their effect is de minimis

Debt Instrument – Measurement & Recognition

Classification/ Measurement	Amortised Cost	FV-OCI	FVTPL
Initial Recognition	FV +Transaction Costs	FV +Transaction Costs	FV
Subsequent Measurement	• Interest income using EIR – in P&L • Changes in FV - Ignored	• Interest income – in P&L • Changes in FV – in OCI	• Interest income – in P&L • Changes in FV – in P&L
Impairment	• Based on Expected Losses	• Based on Expected Losses	• None
Derecognition Gains/Loss	• P&L	• Recycled/transferred from OCI to P&L	• P&L

Equity Instrument – Measurement & Recognition

If an entity elects – cannot be changed during the life of the equity instrument

Classification	FV-OCI	FVTPL
Initial Recognition	FV +Transaction Costs	FV
Subsequent Measurement	• Dividend income – in P&L • Changes in FV - OCI	• Dividend – in P&L • Changes in FV – in P&L
Impairment	• Based on Expected Losses	• None

Fair Value through Profit or Loss

- A financial asset is classified and measured at FVTPL if the financial asset is:
  i. A held-for-trading financial asset
  ii. A debt instrument that does not qualify to be measured at amortised cost or FVOCI
  iii. An equity investment which the entity has **not elected** to classify as at FVOCI
  iv. A financial asset where the entity has elected to measure the asset at FVTPL under the fair value option (FVO).

Financial Liabilities

- Financial liabilities are either classified as:
  - at amortised cost; or
  - at fair value through profit or loss (FVTPL).

Measurement

- At initial recognition a financial liability is measured at **fair value including transaction costs** unless the financial instrument is **carried at FVTPL,** in which case the transaction costs are immediately recognised in profit or loss.
- Subsequent - financial liabilities are either measured at **amortised cost** or at **fair value.**

Measurement (continued)

- Equity investments are measured at fair value; and that in limited circumstances [exception], the **cost is an appropriate estimate of the fair value**, i.e., where:
  - The most recently available information is not sufficient to measure the fair value; or
  - There is a wide range of possible fair value measurements and cost represents the best estimate within that range.

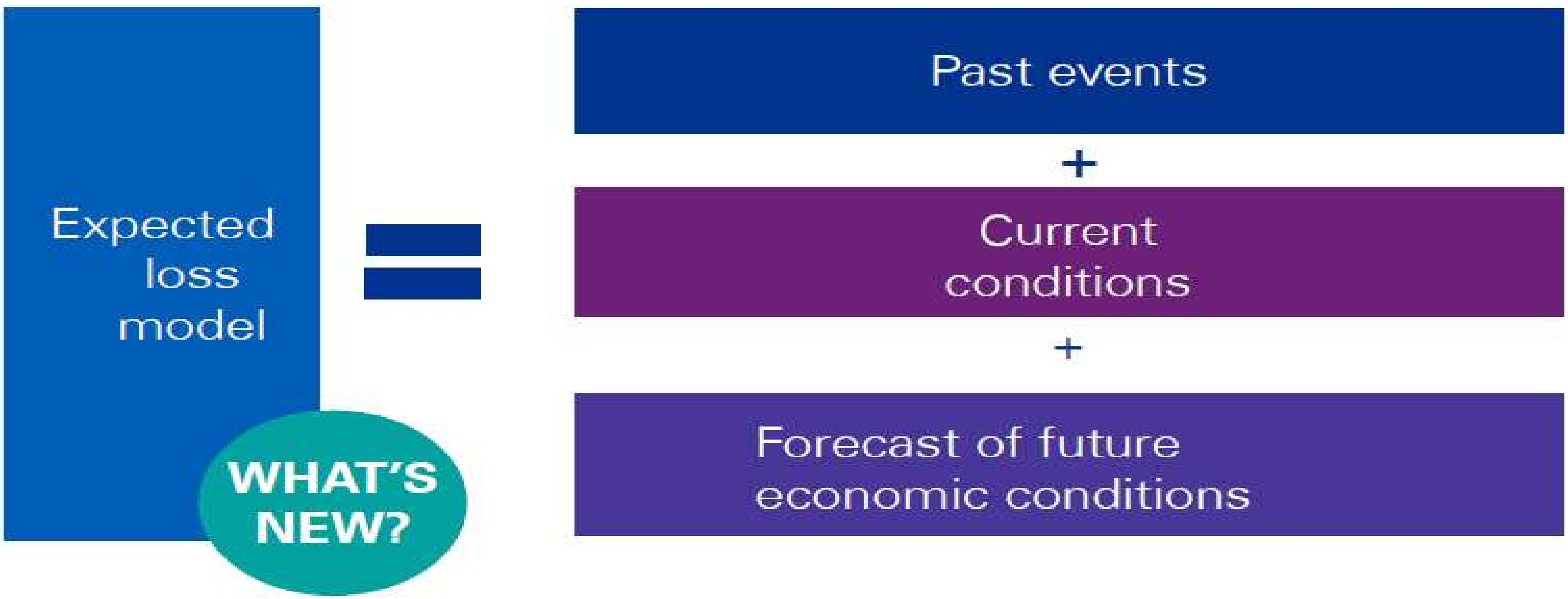
- The above exception does not apply to **equity investments held financial institutions** and investment funds.

Impairment

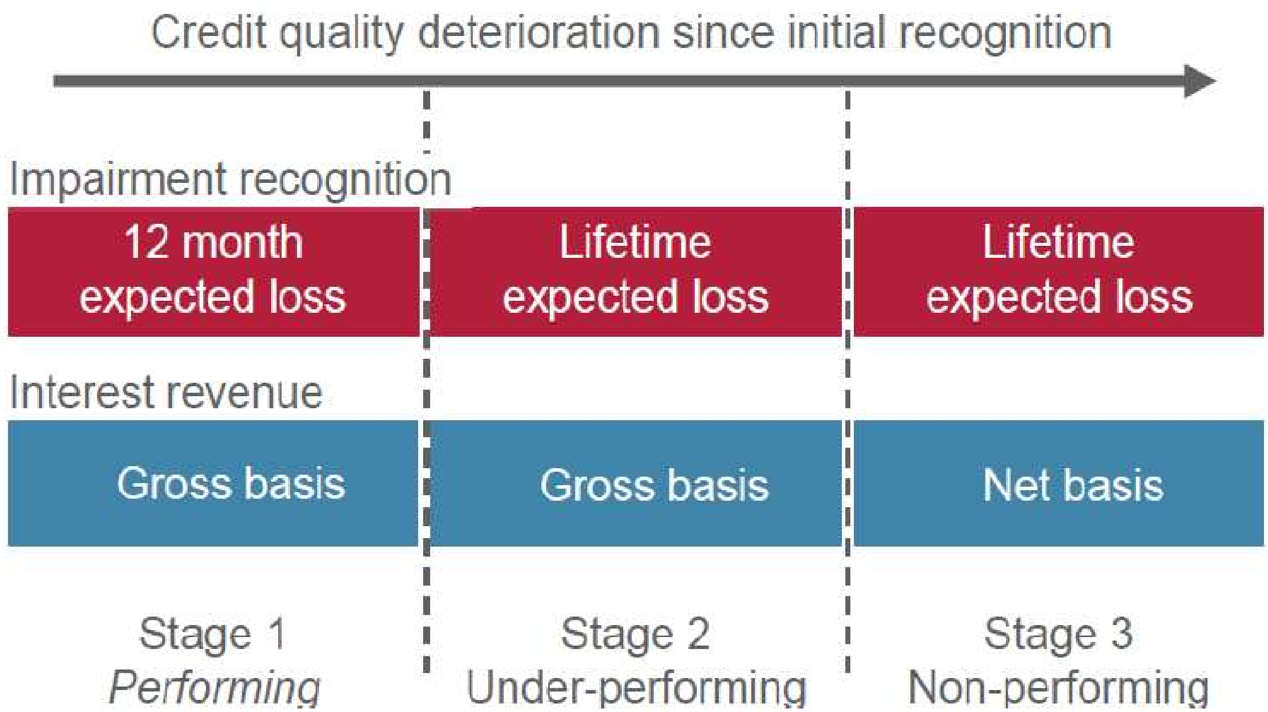
- IFRS 9 requires recognition of impairment losses on a **forward-looking basis** which means that impairment **loss is recognised before the occurrence of any credit event** [expected credit losses ('ECL')].

- Provides for three broad approaches to impairment:
  1. general approach;
  2. **simplified approach for certain trade receivables, contract assets and lease receivables;** and
  3. specific approach for purchased or originated credit-impaired financial assets.

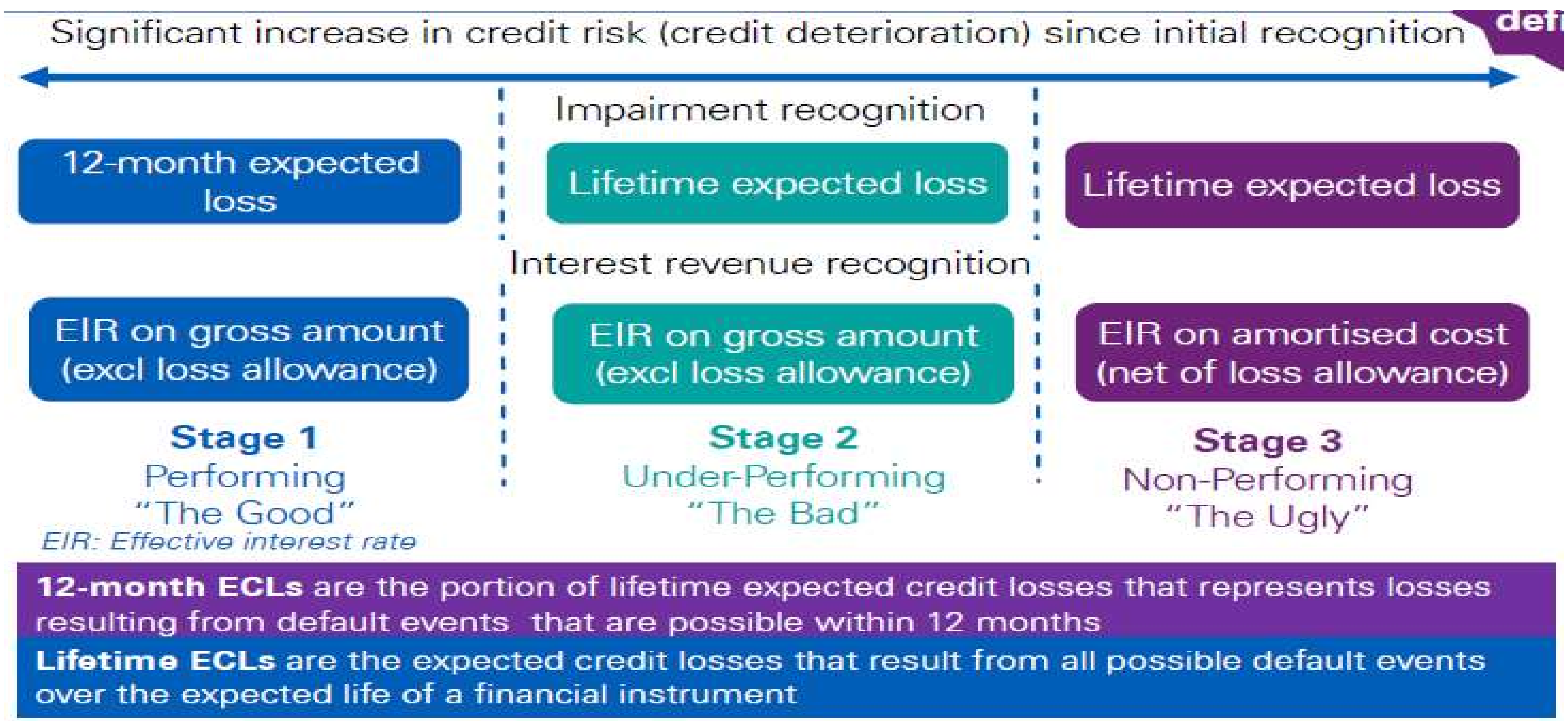
Impairment


Expected loss model
=
Past events
+
Current conditions
+
Forecast of future economic conditions
WHAT'S NEW?

Expected Loss Model



Impairment – General Approach



Key terminologies

- **Credit loss** is the difference between all **contractual cash flows** that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive, discounted at the original EIR or credit-adjusted EIR

- When estimating cash flows for determination of ECL, the entity takes into account:-
  - expected life of a financial instrument
  - all contractual terms of the financial instrument (e.g. prepayment, extension, call and similar options)
  - collaterals held
  - other credit enhancements integral to the contractual terms

Impairment

- **Default** – note defined in IFRS 9 but requires each entity to do so. Must be consistent with that used for internal credit risk management purposes and has to consider qualitative factors such as breach of covenants – including regulatory definition.
  - **Rebuttable presumption that default does not occur later than when a financial asset is 90 days past due**

- **Significant increase in credit risk** – not defined in IFRS 9 an entity decides how to define it – judgement call
  - **Rebuttable presumption of 30 days past due - there is a rebuttable presumption that credit risk on a financial instrument has increased significantly when payments are more than 30 days past due.**

Impairment

- IFRS 9 does not give specific methodology requirements for measuring ECL, instead it provides general guidance stating that the measurement of ECL should reflect:
  a) an **unbiased and probability-weighted** amount that is determined by evaluating a range of possible outcomes;
  b) the **time value of money**; and
  c) **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.

- There are two common approaches to ECL measurement include (i) loss rate approach or (ii) adjusted Basel PD/LGD/EAD approach

Impairment

- *Example: illustrative calculation of lifetime ECL and 12-month ECL for a loan*
- On 31 December 2017, Entity A lends Entity B $100,000. Entity B will repay the loan in 5 annual equal instalments amounting to $25,000 (i.e. $125,000 in total). Calculation of ECL will be based on PD/LGD/EAD model:
  - PD – probability of default (assessed by Entity A)
  - EAD – exposure at default (= amortised cost of the loan)
  - LGD – loss given default (i.e. what % of EAD will not be recovered at default, this should take into account any collaterals held)

Expected Credit Loss

Reporting date	EAD	PD (marginal)	PD (cumulative)	LGD	EIR	Marginal ECL^
					Total	**6,722** 1
2017-12-31	**100,000**	**3%**	**3%**	**80%**	**7.9%**	**2,224** 2
2018-12-31	82,926	3%	6%	80%	7.9%	1,709
2019-12-31	64,500	3%	9%	80%	7.9%	1,231
2020-12-31	44,627	4%	13%	80%	7.9%	1,053
2021-12-31	23,164	4%	17%	80%	7.9%	506

Impairment

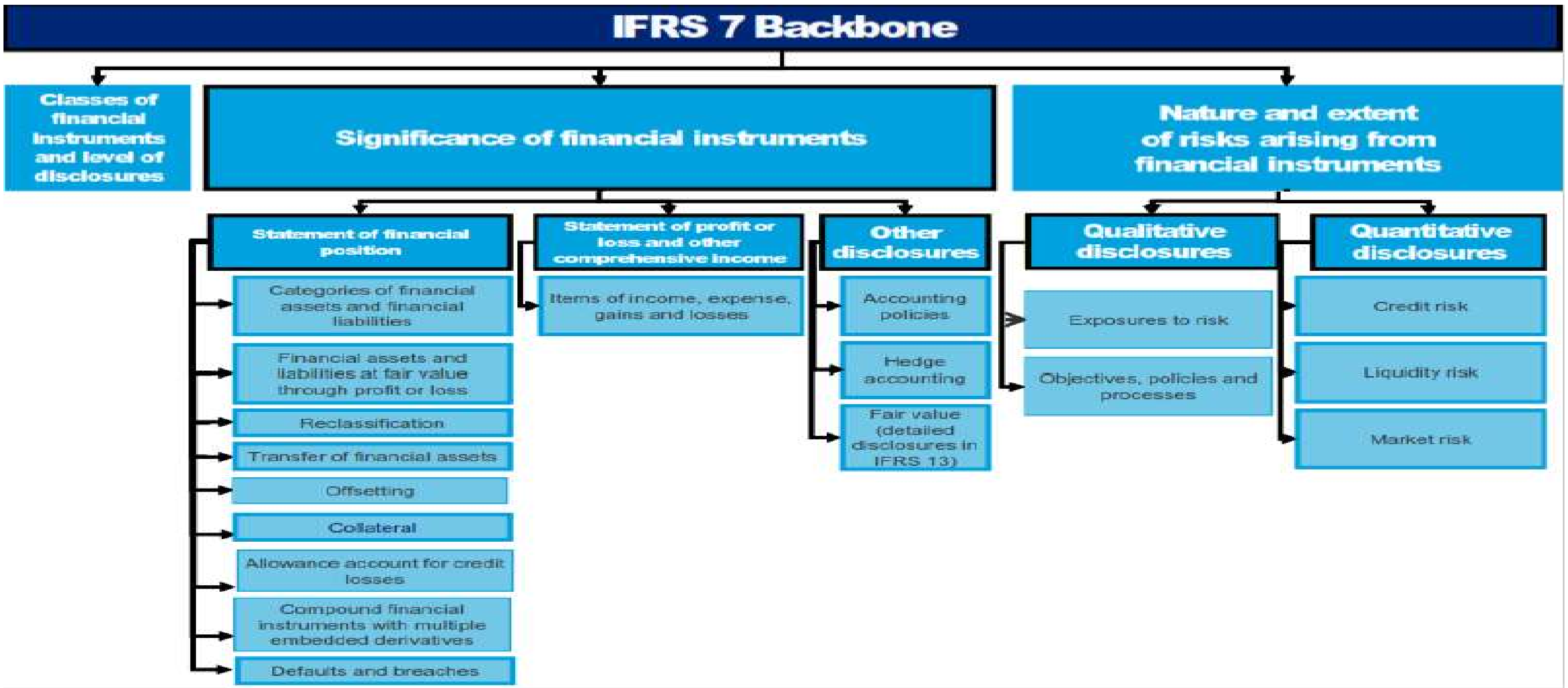
Simplified impairment model

- Next session…

What did we learn from Year 1?

1. Determination of significant increase in credit risk
2. Systems and automation
3. Economic forward guidance
4. Data quality and limitations – undue cost and effort
5. Key regulator involvement
6. 90 days past due rebuttable presumption of default
7. Technical know how
8. Capital impact and income tax implications

IFRS 7 Architecture



Disclosure

- Refer to:
- Annual Report & Audited Financial Statements of:-
  1. KCB Group 2018
  2. CRDB Bank Plc (2018)
  3. Egerton Sacco (2018)

Implication

- Recognition of additional provisions…
- Increased disclosure requirements…
- Transition – Feedback from Banks/Sacco/Other entities on how IFRS 9 impacted their reporting???

Interactive Session

[redacted]