IFRS 9 Financial Instruments

Classification, Recognition Measurements and ECL Model

09 September 2021

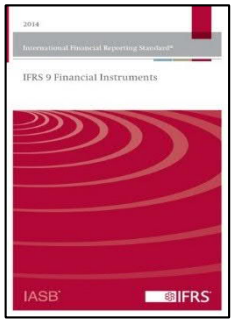
Vision: A world class Professional Accountancy Institute.

Agenda

- Overview of IFRS 9
- Classification and measurement
- Impairment approaches
- Key Challenges
- Q&A

Overview of IFRS 9

- In July 2014, the IASB issued the final version of IFRS 9 Financial Instruments to replace IAS 39 Financial Instruments: Recognition and Measurement, which brings together the three aspects:



1. Classification and Measurement
2. Impairment (expected credit losses)
3. Hedge Accounting

- The standard was effective on 1 January 2018

- Retrospective application with transition reliefs.

Overview of IFRS 9 – Changes

What changed…

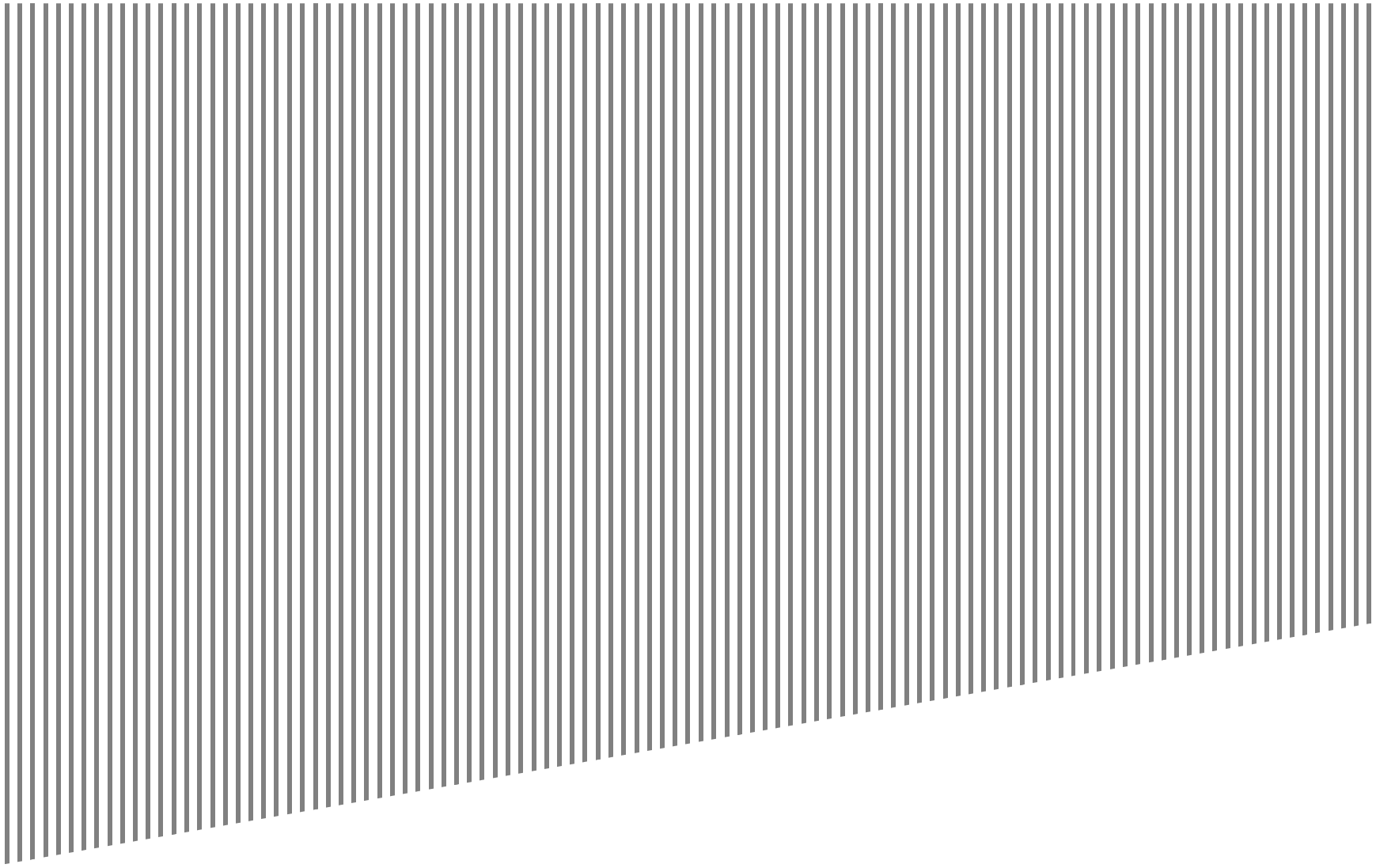
Financial assets

- New principles based classification criteria
- Contractual cash flow characteristics and business models now drive classification
- Impairment assessment only applies to debt instruments at amortised cost & FVOCI
- Impairment assessment for loan commitments and financial guarantee contracts.
- Tainting rule has been expunged
- No need separate embedded derivatives from host contract
- Equities must be measured at fair value

Financial liabilities & Hedge accounting

- Eligible hedge items have been expanded
- No longer required to perform retrospective effectiveness test
- 80 -125% test has been removed
- Designation of hedge relationship continues (even when ineffective) as long as risk management objectives remains unchanged.

Classification and measurement



Question

What are the categories of financial assets under IAS 39?

A. **Loans and receivables, held to maturity, available -for-sale, fair value through profit or loss**

B. **Fair value through other comprehensive income, fair value through profit or loss, amortised cost**

C. **I don't know**

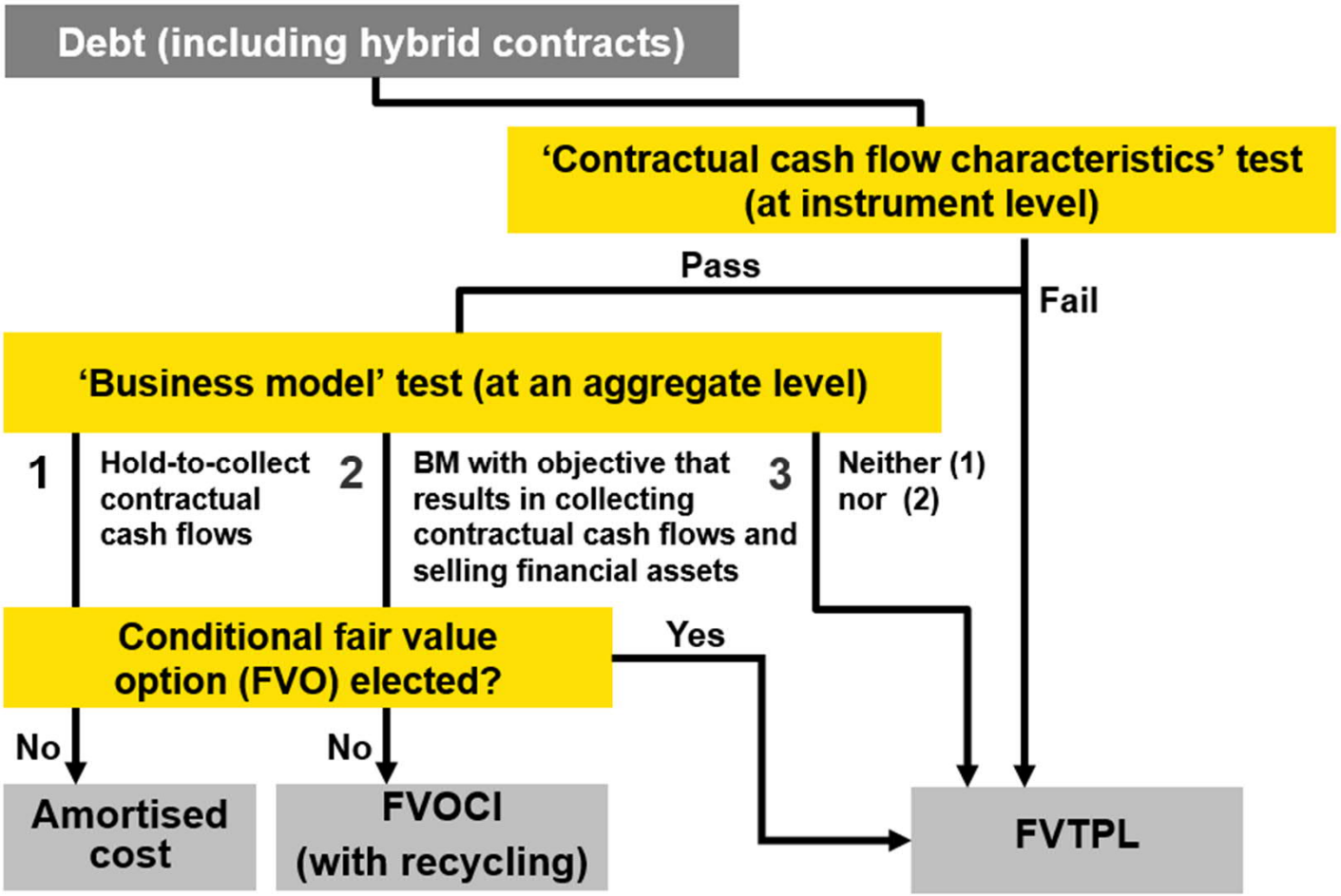
Overview of IFRS 9 - Scope

- Trade receivables & trade payables
- Originated loans & loan liabilities
- Derivative assets & liabilities
- Lease receivables
- Contract assets
- Intra group loans
- Equity investments
- Loan commitments and financial guarantee contracts (FGC) not measured at fair value through profit or loss

What changed – financial assets?

Change in financial asset categorisation		
Place where gains & losses presented	**IAS 39 Financial assets**	**IFRS 9 Financial assets**
Fair value through P&L	Financial assets at fair value through P&L	Financial assets at fair value through P&L (FVTPL)
Fair value movement going through OCI	Available-for-sale financial assets	Debt instruments at FVOCI (with cumulative gains and losses reclassified to profit or loss upon derecognition) (FVOCI- with recycling)
		Equity instruments designated as measured at FVOCI (with gains and losses remaining in OCI, without recycling). (FVOCI- no recycling)
Amortised cost (EIR)	Loans and receivables	Debt instruments at amortised cost
	Held to maturity	

The new classification and measurement model for financial assets

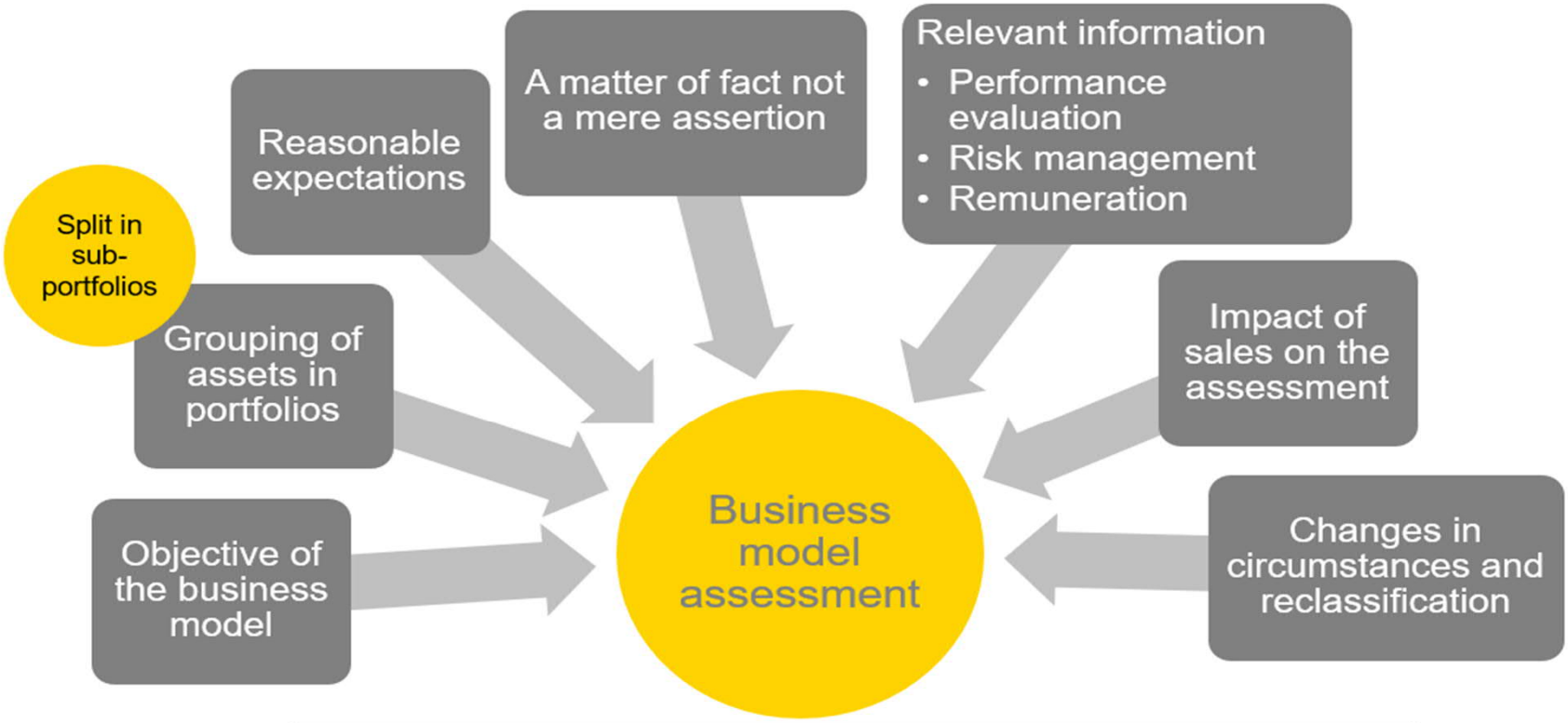


Classification and measurement model for financial assets based on SPPI Test overview

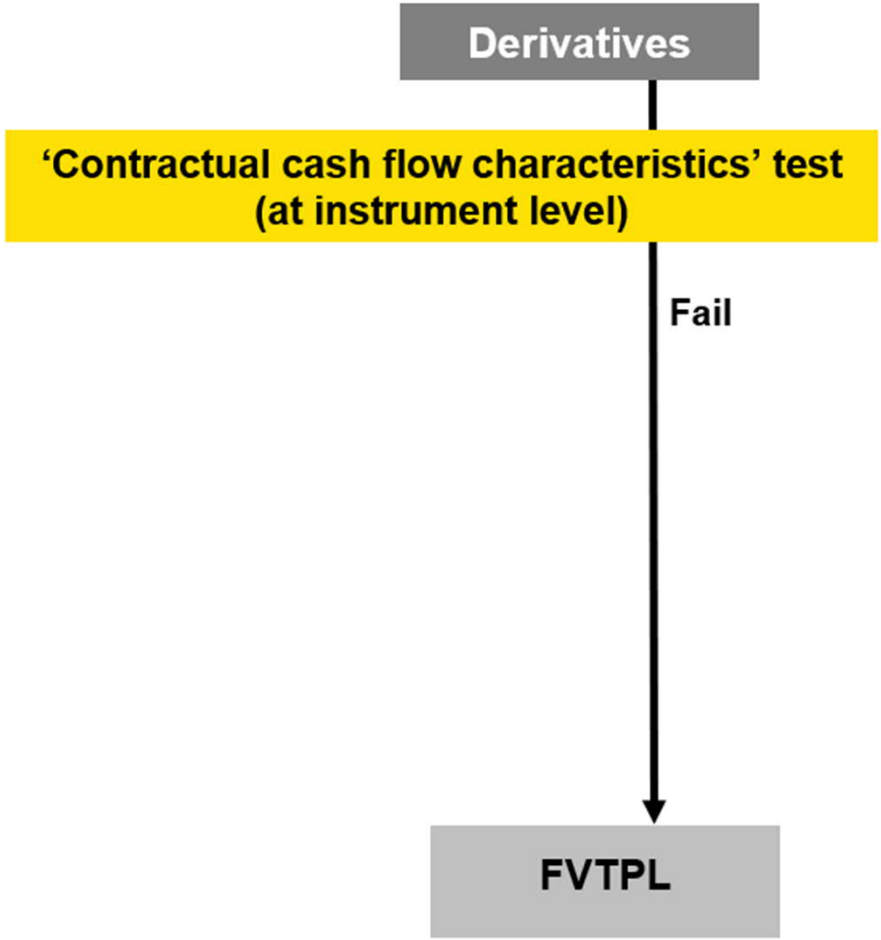
- The contractual cash flows are SPPI, if cash flows are:
  - Consistent with a basic lending arrangement which include consideration for:
    - Time value of money
    - Credit risk
    - Other basic lending risks and costs:
      - Liquidity risk
      - Adminstrative costs
      - Profit margin
  - Do not introduce exposure to risks or volatility unrelated to a basic lending arrangement

- Principal = ‘the fair value of the asset at initial recognition’

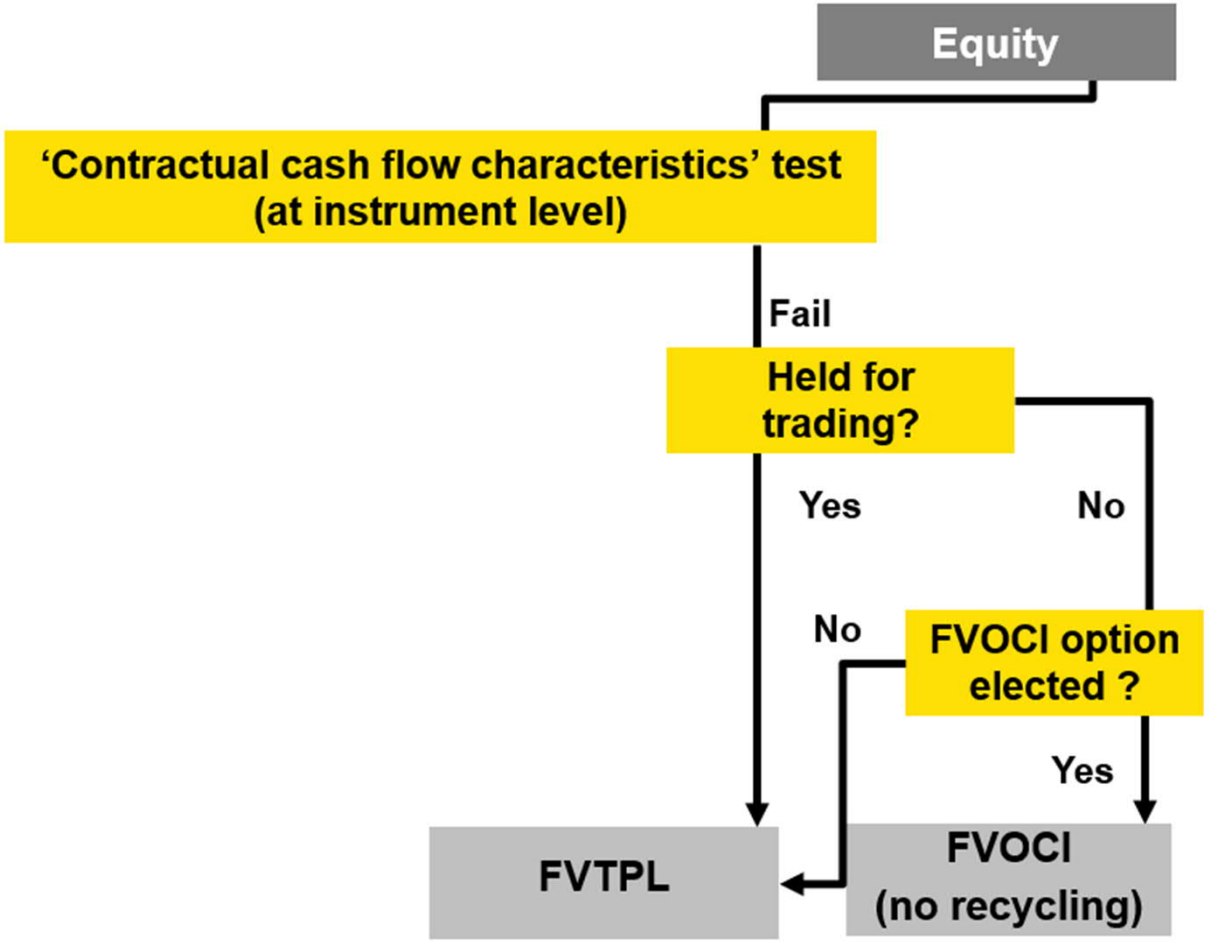
The new classification and measurement model for financial assets – Business Model Test



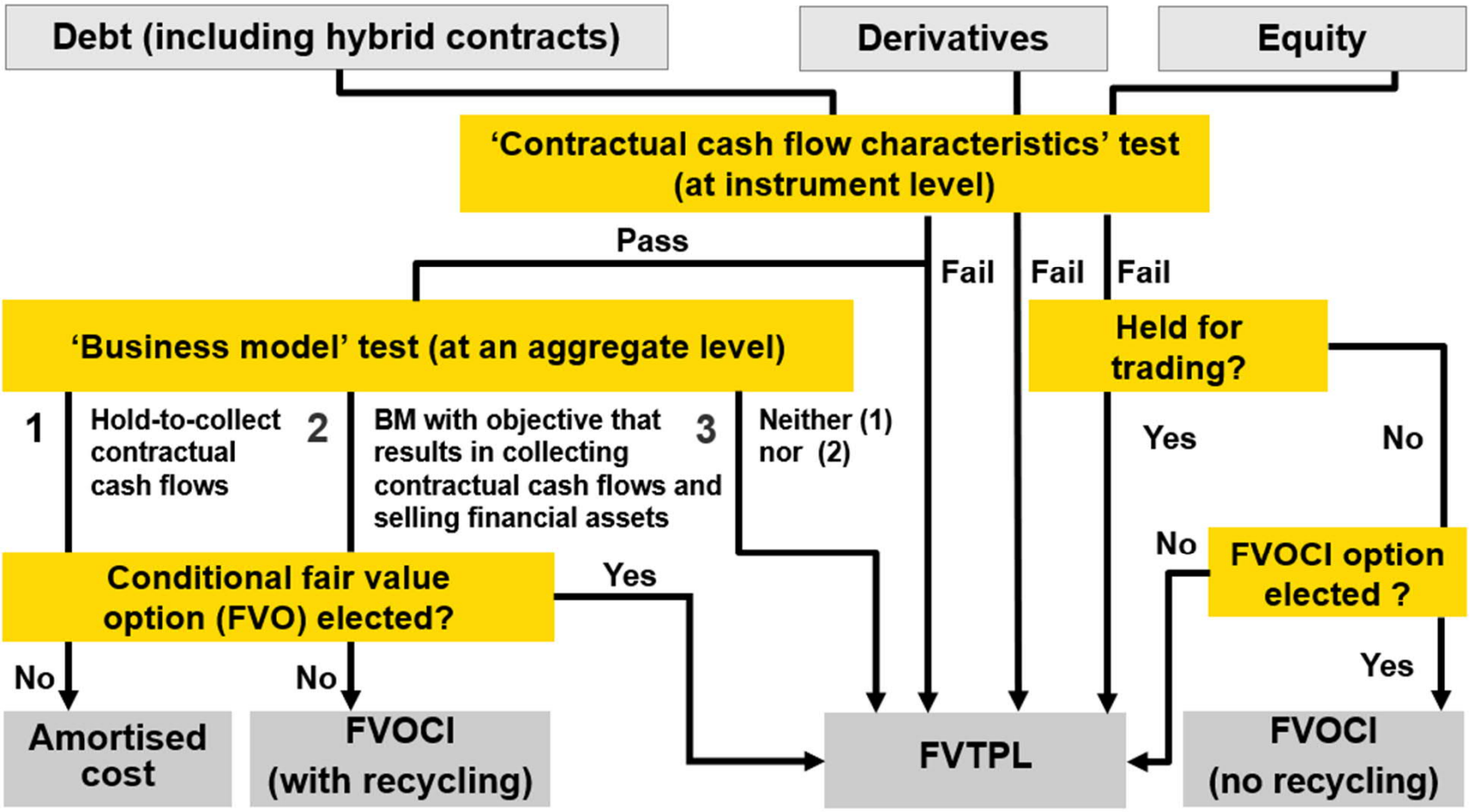
The new classification and measurement model for financial assets



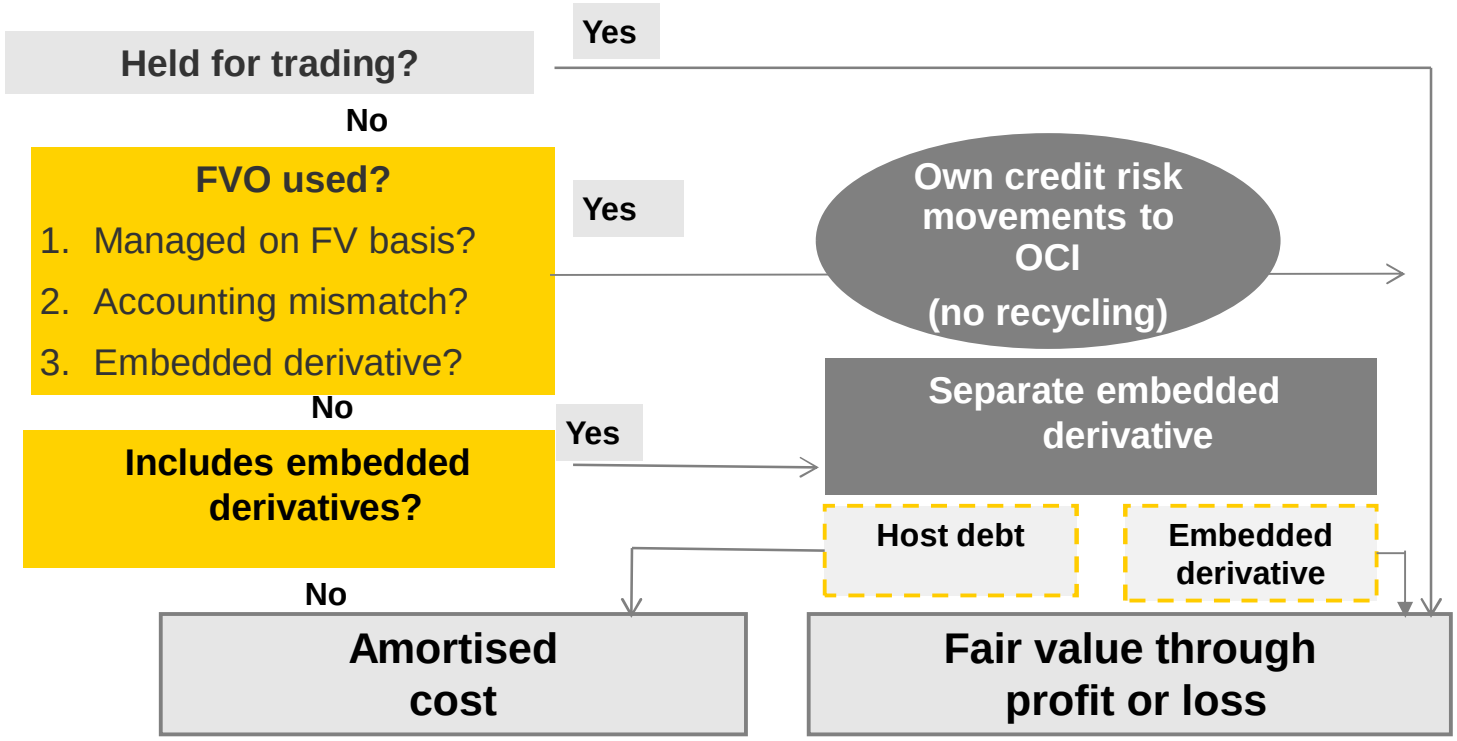
The new classification and measurement model for financial assets



The new classification and measurement model for financial assets



Classification and measurement model for financial liabilities



Classification and measurements Illustrative Examples

Choco Limited (hereafter referred to as 'Choco') is a wholly owned subsidiary of a large retailer. The principal activity of Choco is to manufacture and sell chocolate, both to companies within the group for further processing or distribution, as well as externally to retailers. It has KShs as its functional currency.

The following table lists the financial instruments/assets held by Choco, which will form the basis for the illustrations.

Example 1

Financial Asset	Fact Pattern
Investment in debt instruments	The investment in debt instruments comprises a portfolio of government and corporate bonds. The bonds are plain vanilla in the sense that the contractual terms of the bonds give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Choco holds these bonds for liquidity purposes. Therefore, it may sell some of the portfolio in order to meet cash flow needs (e.g., for acquisitions). This is expected to happen on a regular basis such that the entity expects to sell assets on a more-than-infrequent basis and that those sales are significant in value.

Example 1 Debrief

Financial Asset	SPPI Test	Business Model
Investment in debt instruments	As the government and corporate bonds are plain vanilla and give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, they meet the SPPI test.	The business model is to maintain liquidity for the entity, should the need arise, which leads to sales that are more than infrequent and significant in value. Therefore, the bonds are managed under an objective that results in both collecting the contractual cash flows and selling the bonds. The portfolio of bonds is therefore classified and measured at FVOCI.

Example 2

F/Asset	Fact Pattern
Loan to parent company	Choco has provided long-term finance in the form of an interest free loan to its parent company. The loan is due to be repaid in five years' time at its par value of KShs 1,000,000. A market related interest rate for a loan with similar terms would have been 6% p.a. on initial recognition. Choco intends to hold the loan until its maturity. Neither Choco nor the parent has an option to call or prepay the loan.

Example 2 Debrief

F/Asset	SPPI Test	B/Model
Loan to parent company	The fact that the loan to the parent earns no interest does not mean that it fails the SPPI test. For the purpose of the SPPI test, the fair value at initial recognition is considered 'the principal' for the SPPI test. Unchanged from the requirements of IAS 39 and IFRS 13 Fair Value Measurement, the fair value of a loan that carries no interest is measured as the present value of all future cash receipts, discounted using the prevailing market rate of interest for a similar instrument (similar to currency, term, type of interest rate and other factors) with a similar credit rating . In this example that rate is assumed to be 6%, which results in a present value on initial recognition of KShs 747,258 for a five-year loan of KShs 1,000,000. The fair value at initial recognition is the basis on which an entity calculates the effective interest rate (EIR). This means that, although the loan pays no coupon, Choco still recognises interest revenue at the effective interest rate. The imputed interest is considered compensation for the time value of money, credit risk and other risks and costs under a basic lending arrangement.	Choco intends to hold the loan to collect the contractual cash flows. Consequently, this loan is classified as and subsequently measured at amortised cost.

Example 3

Financial Asset	Fact Pattern
Trade Receivable	Payment in respect of sales is due within 30 days of invoice date. Choco has no intention of factoring/selling its trade receivables.

Example 3 Debrief

Financial Asset	SPPI Test	Business Model
Trade Receivable	The principal is deemed to be the amount resulting from a transaction in the scope of IFRS 15. Choco determines that the trade receivables do not include a significant financing component and, hence, there is no interest or put another way, Choco deems the interest element to be zero. The trade receivables of Choco only involve a single cash flow — the payment of the amount resulting from a transaction in the scope of IFRS 15, which is deemed to be the principal, as stated above. Therefore, the cash flows resulting from the receivables meet the SPPI test of payments of principal and interest despite the interest component being zero.	Choco's intention is to hold the receivables to collect the contractual cash flows. Therefore, they are classified as and measured at amortised cost.

Example 4

Financial Asset	Fact Pattern
Cash and cash equivalent	Cash and cash equivalents comprises a current account, which is a non-interest bearing demand deposit.

Example 4 Debrief

Financial Asset	SPPI Test	Business Model
Cash and cash equivalent	Because of the short term nature of the instrument, Choco recognises the current account at its contractual par amount. Similar to trade receivables, the current account involves one single cash flow which is the repayment of the principal. Therefore, the cash flows resulting from the receivables meet the SPPI test of payments of principal and interest despite the interest component being zero.	Choco holds the current account in order to collect contractual cash flows. The current account is therefore classified as measured at amortised cost.

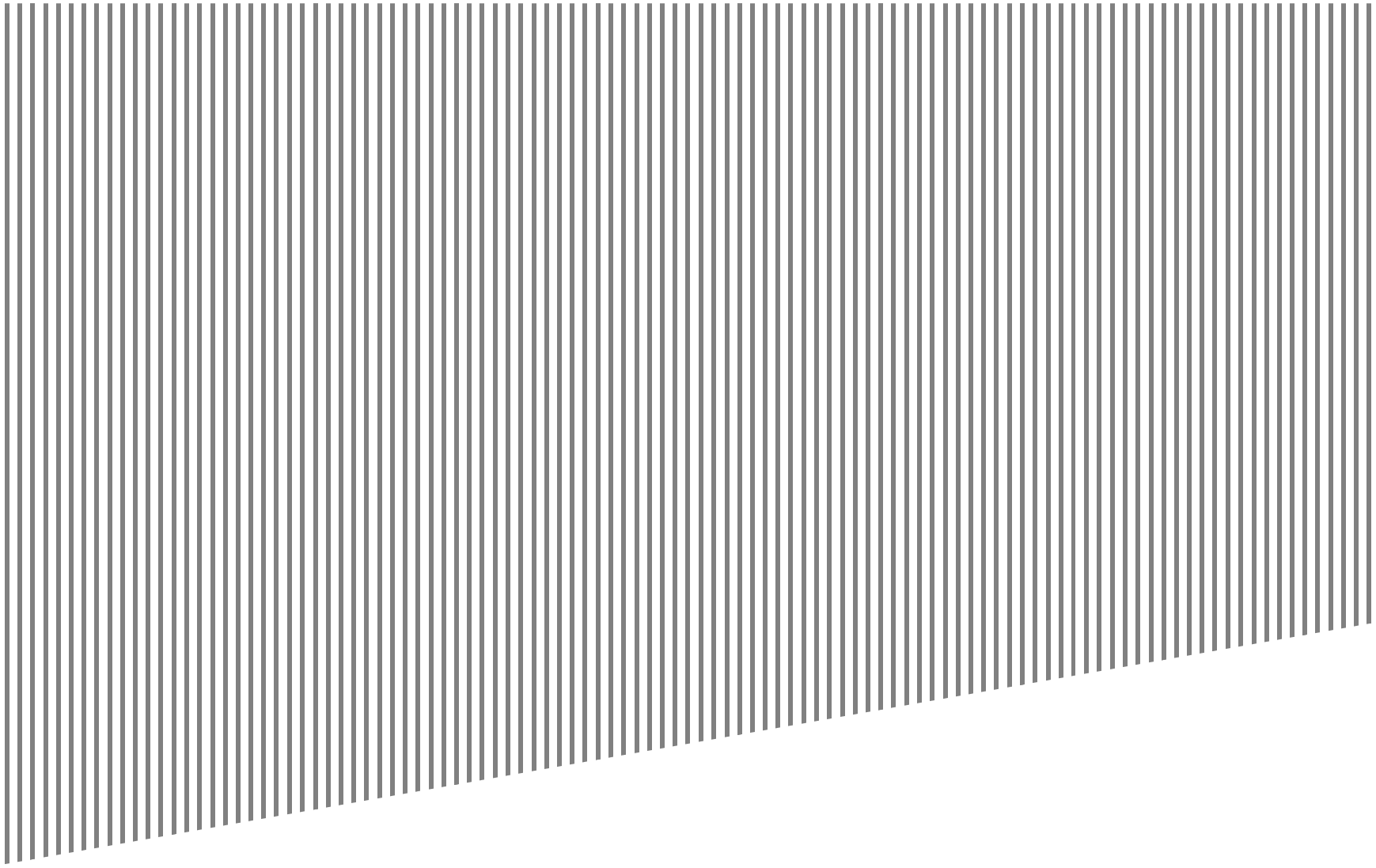
Example 5

Financial Asset	Fact Pattern
Investment in equity instrument	Choco has invested in listed shares of some of its suppliers and customers (the shareholdings of which are all less than 5% of the respective entities). The purpose of this portfolio is to hold the shares for the long term in order to commit to a strategic alliance with the supplier or customer.

Example 5 Debrief

Financial Asset	SPPI Test	Business Model
Investment in equity instrument	Equity instruments fail the SPPI test because the cash flows resulting from such instruments do not represent payments of principal and interest on the principal outstanding.	Choco's intention in respect of the portfolio of shares is to hold them for a long period as a strategic investment. Therefore, due to the fact that shares are not held for trading, Choco is allowed to elect irrevocably to present gains and losses on these equity investments in OCI. This means that Choco need never assess whether the shares are impaired as it will not be able to record any gains on sale through profit or loss. If Choco were actively buying and selling the shares with the objective of realising short-term fluctuations in their price, the shares would be held for trading and would be required to be classified and measured at FVTPL.

Impairments approaches



Question

Which approaches are applied in IFRS 9 ECL calculation :-

A. **Incurred model**

B. **General approach, Simplified approach**

C. **All the above**

Impairment Approaches

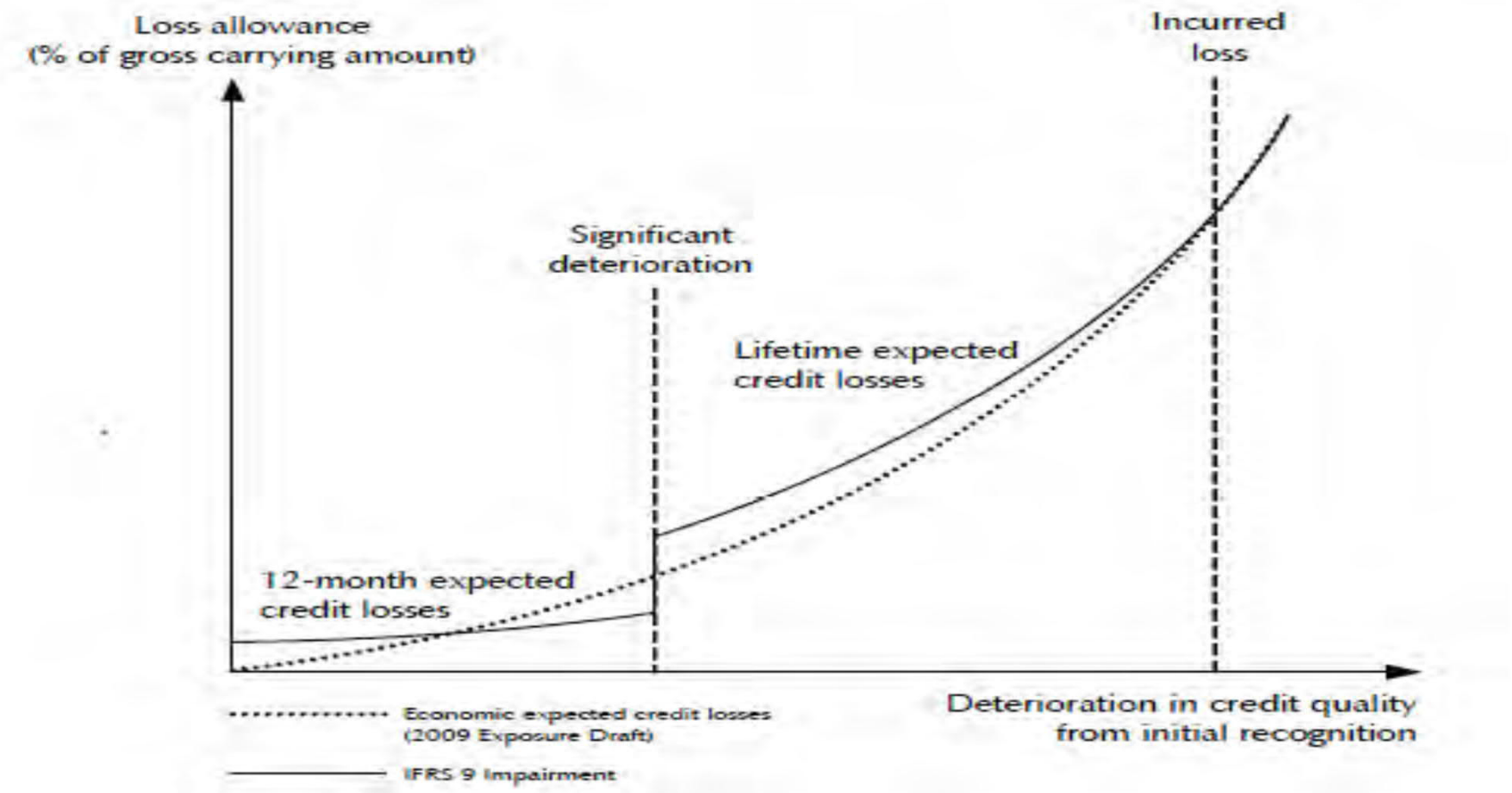
- In applying the IFRS 9 impairment requirements, an entity needs to follow one of the approaches below:-

  - **The general approach** – Under this approach, at each reporting date, an entity recognises a loss allowance based on either 12 months ECLs or lifetime ECLs depending on whether there has been significant increase in credit risk (SICR).

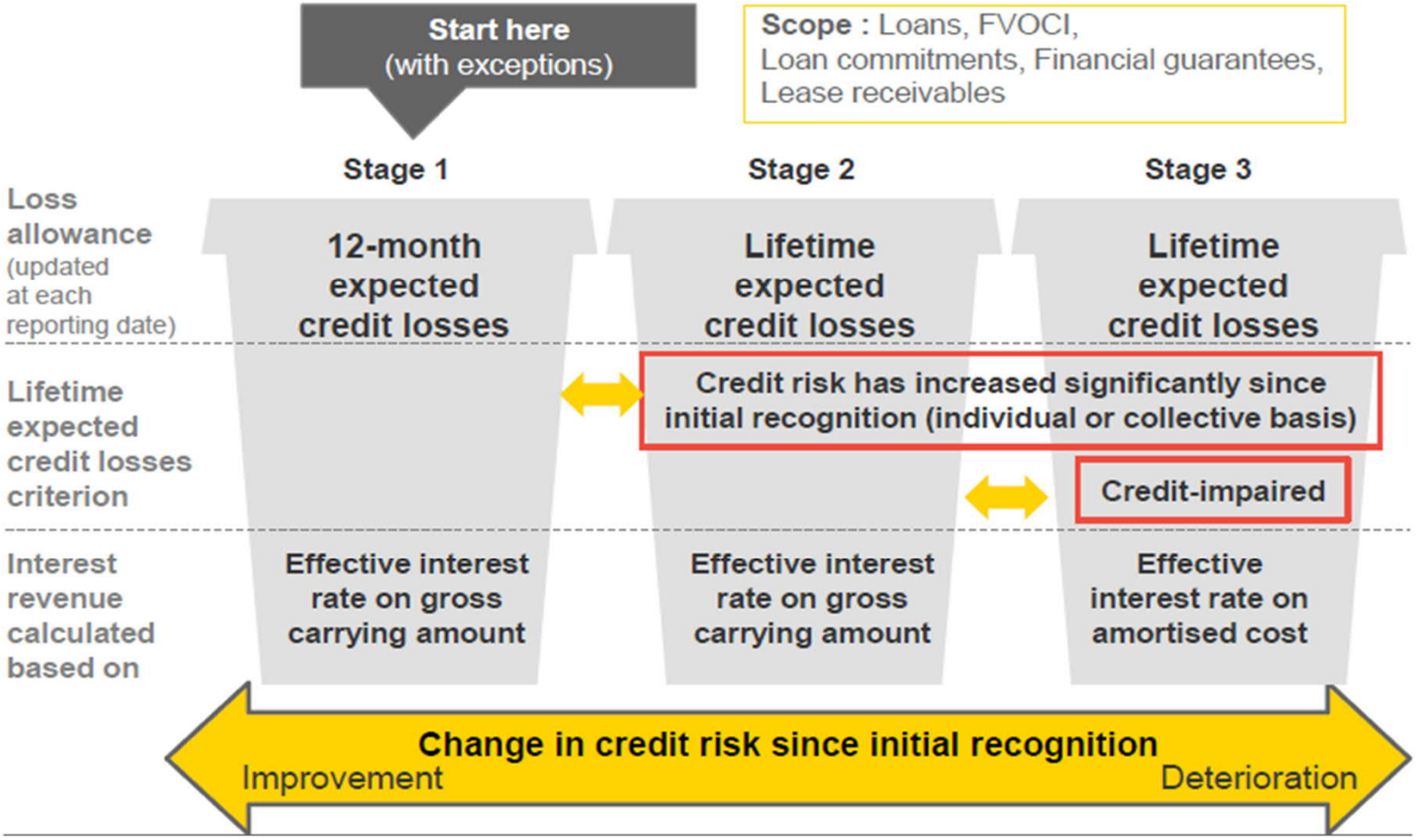
  - **The simplified approach** – The simplified approach does not require an entity to track the changes in credit risk , but, instead, requires the entity to recognise a loss allowance based on the lifetime ECLs at each reporting date, right from origination. This is applicable for contract assets and trade receivables (that do not contain a significant financing component) and lease receivables.

  - **Purchased or originated credit-impaired assets** – This caters for financial asset(s) that are ***credit-impaired*** on purchase or origination (initial recognition). An entity only recognises the cumulative changes in lifetime expected credit losses discounted using the credit-adjusted effective interest rate determined at initial recognition for these assets. There is no 'day one' or 12-month ECL.

General Approach

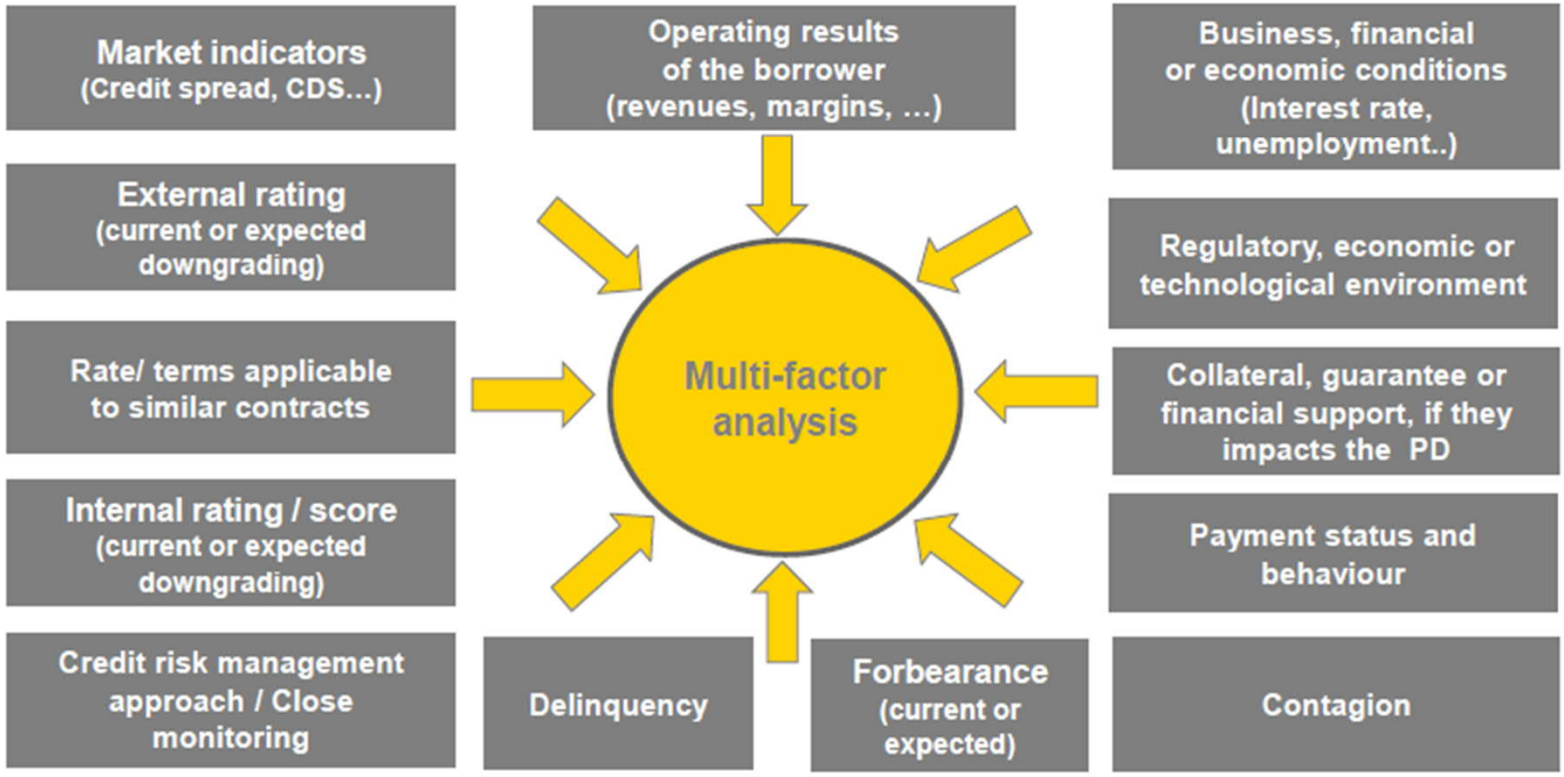


General approach - Measurement of ECL

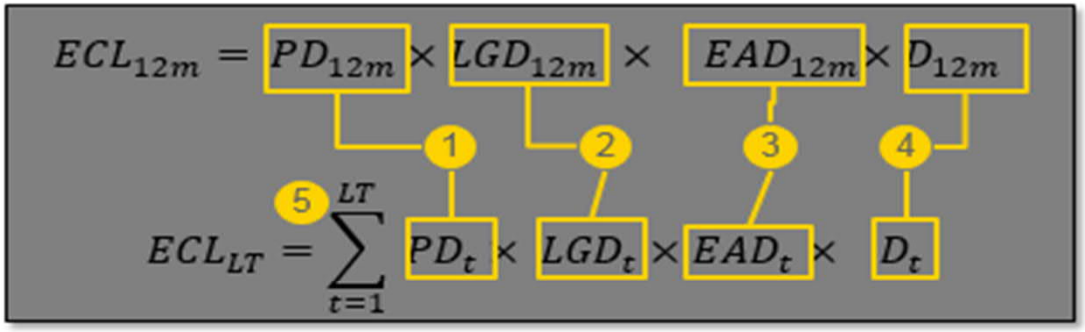


General Approach significant deterioration (SIC)

- Non-exhaustive list of factors or indicators to consider
  - Deteriorations that have already occurred or are **only expected**



General approach - Calculation of Expected Credit Losses (ECL)



1 **PD**
- Probability of defaulting in period t
- Expected to be unbiased, i.e. not down turn

2 **LGD**
- Forecasted economic loss if default happens in period t
- Expected to be unbiased

3 **EAD**
- Projected exposure if default occurs in period t
- Behavioural payments capped at the contractual lifetime unless revolving

4 **D**
- Discount factor to discount cashflows (effectively in this case losses) to the reporting date
- Discounts at EIR

5 **LT**
- Summation of individual period (typically year) ECLs to arrive at lifetime ECL
- Required provision balance for stage 2 & 3 assets

Transition criteria
- Determine transition from stage 1 to stage 2 (or 3)
- Based on changes in default risk (not loss) likelihood since origination

General Approach - Example
Stage 1 – 12 Months ECL

- On January 1, 2016, Bank A originates a 9 year bullet corporate loan with a gross carrying amount of $1,000,000
  - No transaction costs, no prepayment or call options
  - Fixed interest rate : 3%
- The loan is in stage 1 at origination date
- At that date, based on expectations for instruments of similar credit quality, the credit quality of the borrower and the economic outlook for the next 12 months, calculation of the 12 months ECL is based on the following inputs :
  - 12 month PD = 0.13%
  - Lifetime PD (9 years) = 2.7%
  - LGD = 25% *
  - EAD = $1,000,000
  - Effective interest rate : 3%
  - Years to maturity : 9 years

Allowance on Day 1 ⇨ P&L impact

$$\text{12-month expected credit losses} = \frac{\text{12-month PD} \times \text{LGD} \times \text{EAD}}{(1+\text{EIR})^{0.5}}$$

$$= \frac{0.13\% \times 25\% \times \$1{,}000{,}000}{(1+3\%)^{0.5}}$$

$$= \$320$$

** After valuing its collateral (and discounting the cash flows that would be received from the sale of the collateral, based on the time expected to be taken to realise it), Bank A assumes that 25% of the gross carrying amount will be lost if the loan defaults*

*** Discounting is based on a period of 6 months as it is assumed that 6 months is the average point of default*

General Approach Illustrative example Stage 2 – Life time

- On 31 December 2017, after 2 years from origination date, the loan has shown signs of significant increases in credit risk but has not yet defaulted
  - Years to maturity : 7 years
  - EAD = $1,000,000
  - **12 month PD = 1% as compared to 0,13% at origination date**
  - **Lifetime PD (7 years) = 11.8% as compared to a lifetime PD (for years 3-9) of 2.66% forecasted at origination date**
  - LGD = 27%
  - Effective interest rate : 3%

Reclassification of the loan to Stage 2 on December 2017

General Approach Illustrative example Stage 2 – Life time (continued)

- Bank A applies the marginal expected credit loss approach to derive the lifetime expected credit loss allowance.

Time	Cumulative PD	Delta PD	LGD	EAD	Marginal expected credit losses (undiscounted)	Marginal expected credit losses (discounted at EIR (*))
		(a)	(b)	(c)	(d)=(a)*(b)*(c)	
1 year	1,00%	1,00%	27%	1 000 000	2 700,00	2 660
2 years	2,20%	1,20%	27%	1 000 000	3 240,00	3 099
3 years	3,72%	1,52%	27%	1 000 000	4 104,00	3 812
4 years	5,77%	2,05%	27%	1 000 000	5 535,00	4 991
5 years	8,02%	2,25%	27%	1 000 000	6 075,00	5 318
6 years	10,06%	2,04%	27%	1 000 000	5 508,00	4 682
7 years	11,81%	1,75%	27%	1 000 000	4 725,00	3 899
						28 462

(*) Assumption that, year after year, 6 months is the average point of default

Allowance as of December 31, 2017
= lifetime expected credit losses

General Approach Illustrative example Stage 2 – Life time (continued)

- On 31 December 2019, the loan defaults and is moved to Stage 3
  - EAD = $1,000,000
  - Years to maturity : 6 years
  - **12-month PD = 100%**
  - **Lifetime PD (6 years) = 100%**
  - LGD = 30%
  - Effective interest rate : 3%

Lifetime expected credit losses = Lifetime PD * LGD * EAD
= 100% * 30% * 1,000,000 = $300,000

Simplified Approach - Illustrative example
Life time - Lifetime ECL

Choco concludes that its trade receivables do not include a significant financing component because they are due within 30 days of the invoice date.

Hence, Choco would need to apply the simplified approach and recognise lifetime ECLs on the trade receivables.

Choco applies the provision matrix as a practical expedient to calculate ECLs under the simplified approach. Choco has a portfolio of trade receivables of KShs 30 million as at 31 December 2017 and operates only in one geographical region.
The customer base consists of a large number of clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms.

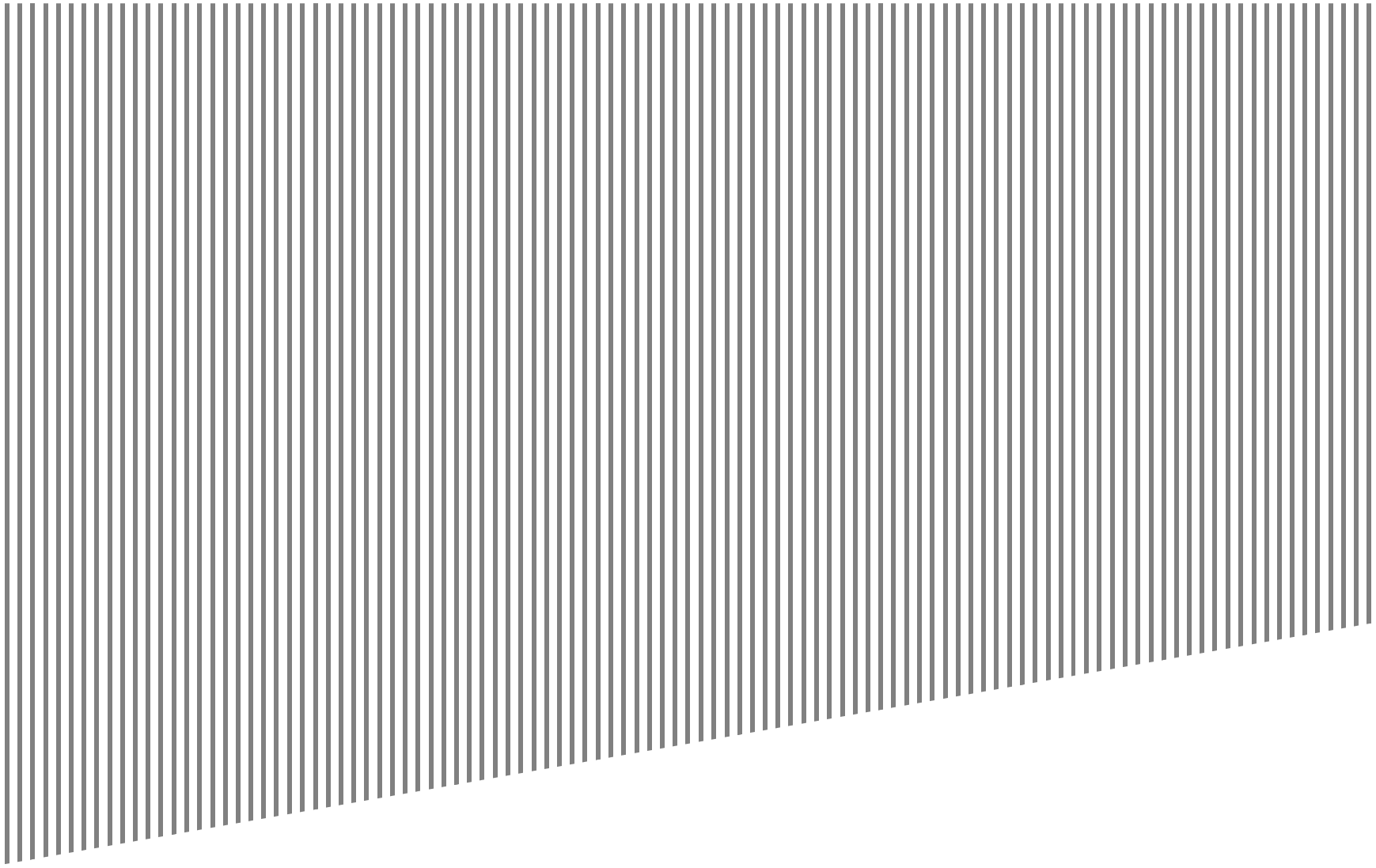
Simplified Approach - Receivables

	Current	1-30 days past due	31-60 days past due	61-90 days past due	More than 90 days past due
Loss rate	0.3%	1.6%	3.6%	6.6%	10.6%

	Gross carrying amount	Lifetime ECL allowance (Gross carrying amount x lifetime ECL rate)
Current	CU15,000,000	CU45,000
1-30 days past due	CU7,500,000	CU120,000
31-60 days past due	CU4,000,000	CU144,000
61-90 days past due	CU2,500,000	CU165,000
More than 90 days past due	CU1,000,000	CU106,000
	CU30,000,000	**CU580,000**

In determining lifetime ECLs for lease receivables without a significant financing component, the time value of money will not need to be considered as it is insignificant. The ECLs will therefore not need to be discounted or, if discounted, it would be a rate of 0%.

Challenges, lessons learned and way forward



Question

For purpose of concluding IFRS 9 ECL model calculations for reporting, our finance team involves:-

A. **Specialist – specialised internal team/external consultants**

B. **No Specialist involved – Finance team computes ECL for reporting**

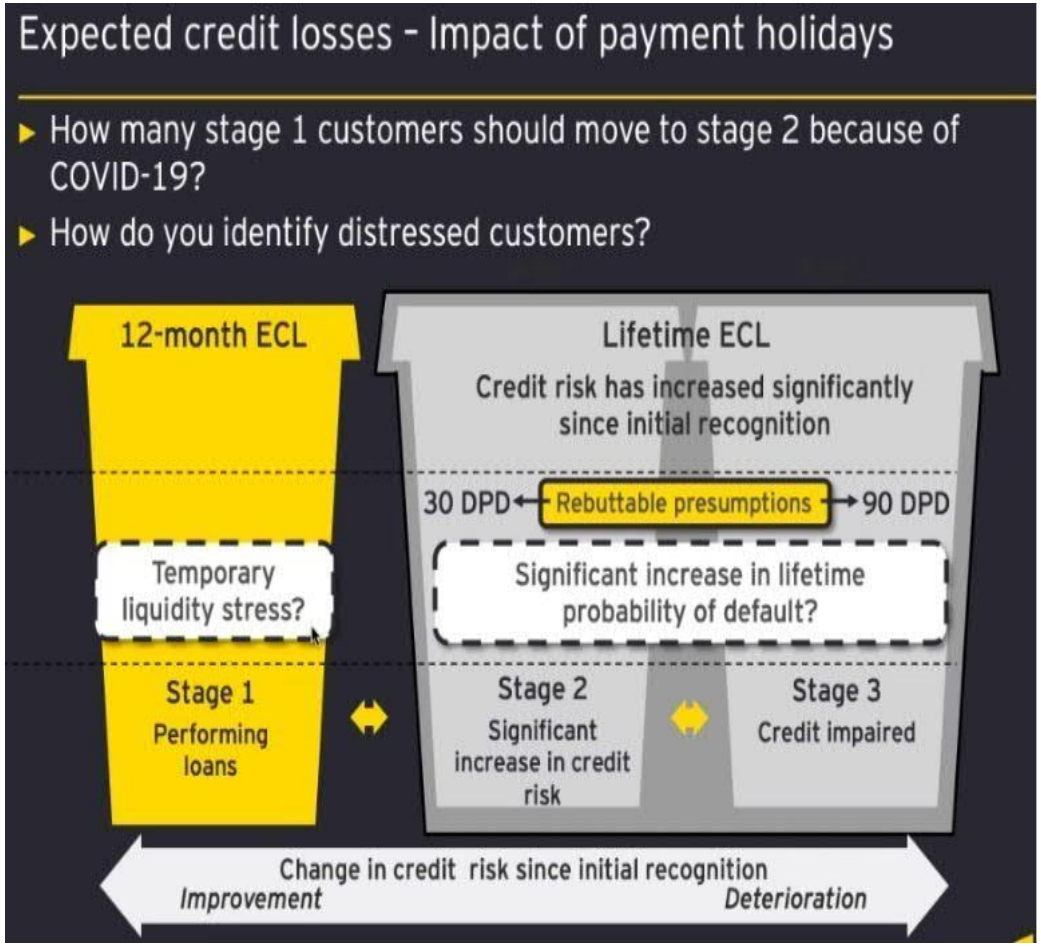
C. **Non of the above – our organisation do not have financial instruments.**

Calculation of Expected Credit Losses (ECL)

IFRS 9.5.5.17 requires an entity to measure expected credit losses of a financial instrument in a way that reflects:

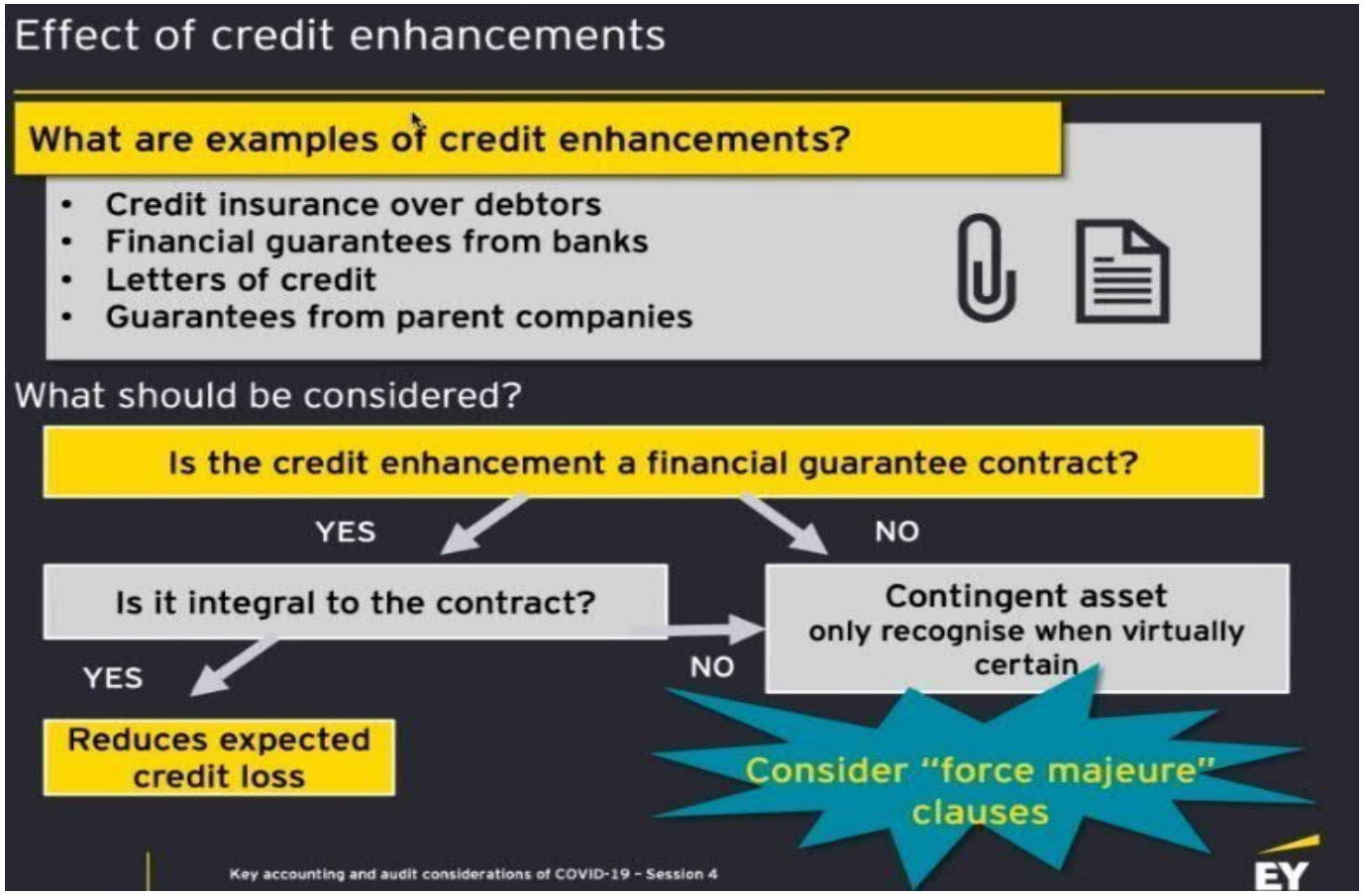
- An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- The time value of money;
- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

COVID 19 – ECL Considerations



- Adjustments to consider
  - Days past due arising from lock down/restrictions
  - Historical default and loss data
  - Additional/different matrices e.g., risk concentration per COVID-19 affected sectors
- Impact on forward looking information
  - Updating scenarios for COVID-19
  - Consider multiple scenarios and allocate weights
  - Impact of lockdown/restrictions
  - Impact on economy e.g., unemployment rates
  - Changes to interest rates
  - Relief provided by government or bank
- Collateral
  - Supply, demand and affordability in case of foreclosure
  - Market values and forced sale values/hair cuts
  - Reputation - social, political impact on enforceability
  - Legal considerations
- Impact of relief given to debtors
- Credit enhancements

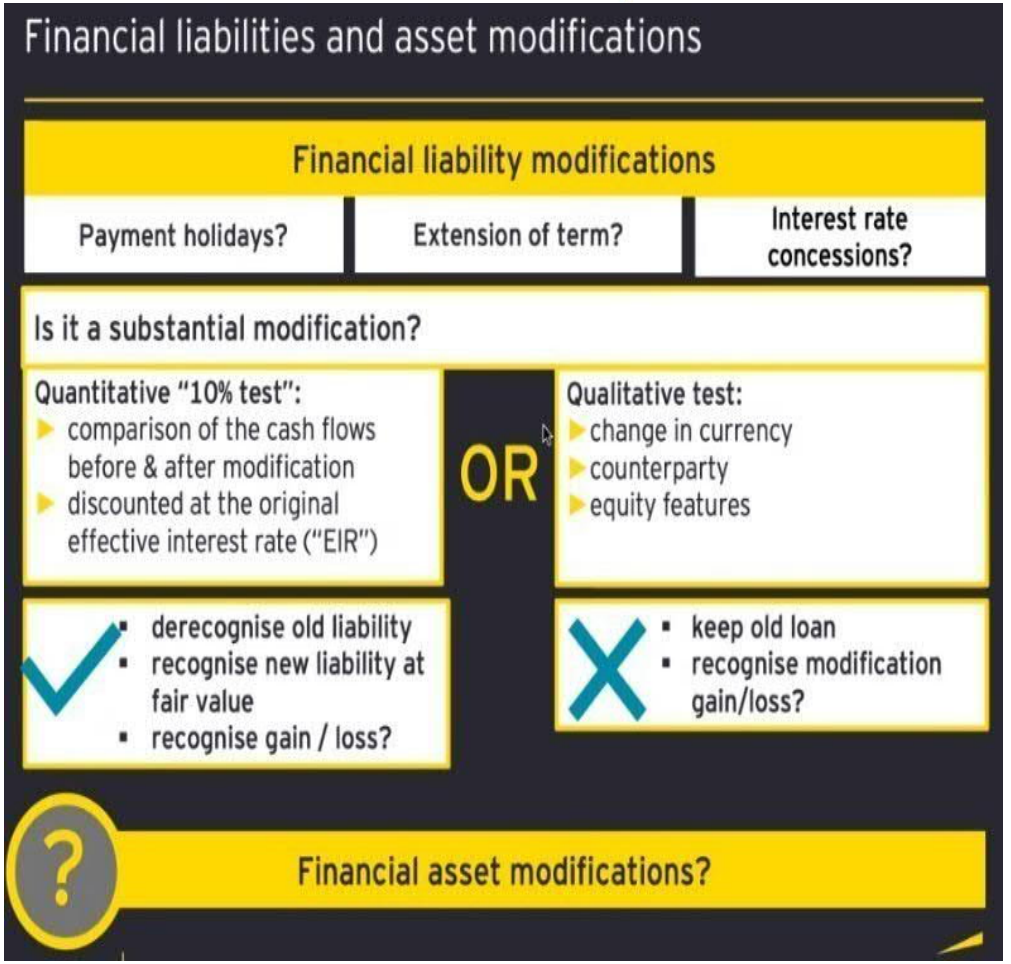
COVID 19 – ECL Considerations
Credit enhancements



- Should not be subject to force majeure provisions and hence not enforceable
- Grantor should have the ability to honour the pledge

COVID 19 – ECL Considerations
Modification of financial instruments

- IFRS 9 provides guidance for financial liabilities
- Develop appropriate policy for financial assets
- Consider facts and circumstances
- Common examples, which are generally not expected to result in derecognition of financial assets include:
- Payment holidays and term extensions:
  - Suspension of payments and extension of the loan repayment date by 6 months
  - Bank continues to accrue interest during the suspension period
- Forgiveness of a portion of a financial asset, e.g. 3- months worth of interest



Questions