IFRS accounting for Reporting financial performance

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CFRR Centre for Financial Reporting Reform

WORLD BANK GROUP

EAASURE

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Disclaimer

Unless specified otherwise, the accounting requirements that are the subject matter of this presentation are the IFRS Standards as issued by the IASB that are applicable on or after 1 January 2024

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Aims

- Deepen your understanding of IAS 32 Judgements
- Deepen your understanding of IFRS 9 Judgements:
  - Classification of assets
  - Measurement of assets
  - Classification of liabilities

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Some important definitions

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Introduction

- IAS 32 *Financial Instruments: Presentation* sets out the principles for the presentation and classification of financial instruments
- The recognition and measurement of financial instruments are the subjects of
  - IFRS 9 *Financial Instruments* and
  - IAS 39 *Financial Instruments: Recognition and Measurement* (certain hedging relationships)
- IFRS 7 *Financial Instruments: Disclosures* sets out disclosures of financial instruments

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IAS 32
Scope and Objective

- Principles for the classification of financial instruments
  - Liability vs. equity classification
  - Instruments with both a liability and an equity component
- Guidance on presentation
  - Deals with all types of financial instruments
  - Contract to buy or sell a non-financial item that can be settled net

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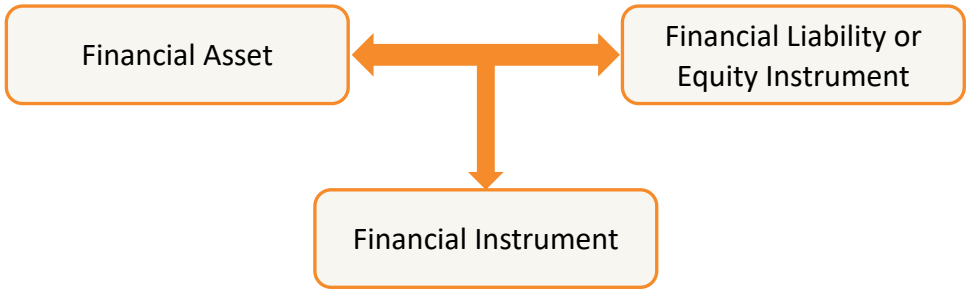
Definitions

» A financial instrument is a **contract** that gives rise to
  » a financial asset of one entity and
  » a financial liability or equity instrument of another



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Definitions
Financial asset

A financial asset is any asset that is:

» Cash,

» Equity in another entity

» Right to receive cash or another financial asset,

» Right to exchange instruments under potentially favourable terms or

» Certain contracts that may be settled in entity's own equity

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Definitions
Financial asset

- Cash,
- Equity in another entity
- Right to receive cash or another financial asset,
- Right to exchange instruments under potentially favourable terms or
- A contract that may be settled in entity's own equity
  - Non derivative where entity will or may receive variable number of its own equity instruments, or
  - A derivative that may be settled other than by exchanging a fixed amount of cash for a fixed number of the entity's own equity instruments

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Example
Kafana Coffee Company Limited (KCC)

KCC Ltd operates in Macedonia, trading globally in coffee beans.

- It buys and sells beans on cash and credit, in Denar and in US Dollars.
- It enters into forward purchases and sales of coffee beans.
- To limit volatility, it has permission to hold US Dollars for expenses.
- Excess cash is invested in Macedonian government treasuries.
- It also holds a small stock of gold coins as protection against devaluation of the Denar.
- It lends money to suppliers to secure and expand supplies.

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Example
Financial assets

KCC Ltd has the following assets - which are financial assets?

Assets at 31 December 20x3 (year end)	Financial asset?
1. Denar currency held on the premises	
2. USD bank balances	
3. Trade receivable	
4. Coffee beans	
5. Investment in government treasury bills	
6. Gold coins	
7. Staff loans	

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Definitions
Financial liabilities

» Obligation to deliver cash or another financial asset,

» Obligation to exchange instruments under potentially unfavourable terms or

» Certain contracts that may be settled in entity's own equity

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Definitions
Financial liability

- Obligation to deliver cash or another financial asset,
- Obligation to exchange FIs under potentially unfavourable terms or
- a contract that will or may be settled in entity's own equities
  - Non derivatives
    - That the entity is or may be obliged to deliver a variable number of its own equity instruments, or
  - Derivatives
    - That will or may be settled other than by exchanging a fixed amount of cash for a fixed number of the entity's own equity instruments

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Example
Financial Liabilities

KCC has the following liabilities – which are financial liabilities?

Liabilities at 31 December 20x3 (year end)	Financial liability?
1. Denar bank overdraft	
2. Trade Payable	
3. Outstanding account to pay for gold coins purchased	
4. Fair value liability of forward sales	
5. Liability for severance pay	
6. Provision for litigation expenses	

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Definitions
Equity Instrument

- Residual interest in assets of an entity after deducting its liabilities
- Excludes any instrument with an obligation to:
  - pay cash or another financial asset or
  - exchange financial assets and financial liabilities under potentially unfavourable conditions.
- If settled in issuer's own equity, then contract must be fixed-for-fixed
- An obligation to issue a fixed number of equity shares is not a liability because it cannot result in a loss to the entity

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Example
Equity Instrument

KCC has issued a number of financial instruments as long term funding:

- Ordinary shares of 1 Denar
  - At a non-redeemable premium of 5 Denar per share
- Non-redeemable, non-cumulative preference share
- Non-cumulative preference share redeemable at the option of the issuer
- Non-cumulative preference share redeemable at the option of the holder
- A deeply subordinated bond (ranks behind the preference shares)

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Example
Equity Instrument

KCC has issued financial instruments as long-term funding, which are equity?

Equity at 31 December 20x3 (year end)	Equity instrument
A. Ordinary shares of 1 Denar	
B. Non-redeemable, non-cumulative pref shares	
C. Non-cumulative pref share redeemable at the option of the issuer	
E. Non-cumulative pref share redeemable at the option of the holder	
5. Subordinated bond (ranks behind pref shares)	

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Definitions
Equity Instrument continued

- A puttable instrument is equity if:
  - It entitles the holder to a pro rata share of net assets (liquidation)
  - The instrument is the most subordinate.
  - No other obligation to deliver cash or another financial asset.
- The expected cash flows are based substantially on profit or loss, the change in net assets, or the change in fair value of the entity.

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Definitions
Equity Instrument continued

Convertible debt

- Has both the characteristics of debt and equity
- IAS 32 requires that instrument be split and recorded as two separate components
  - Liability : Measured by reference to the fair value of the liability
  - Equity : Difference between issue value and fair value of the liability
- Determination made on day 1
- No gain or loss recognised on day 1

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Definitions
Equity Instrument continued

Treasury Shares

- Equity instruments that an entity or group hold(s) in itself
- Treasury shares are deducted from equity
- Gain or loss on purchase/sale of treasury shares recognised directly in equity

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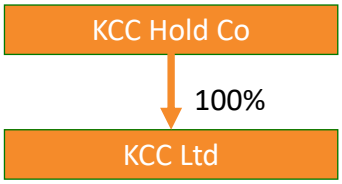
Example
Treasury shares

» KCC Ltd is a 100% owned subsidiary of KCC Hold Co

» On 1 March 2022, KCC purchased 100 shares in KCC Hold Co at a price of Denar 200 each

» On 31 December June 2022, KCC still held the shares. The share price on that day was Bir 225 each



Buys 100 shares in Hold Co of 200 each(value 225)

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Example
Treasury shares continued

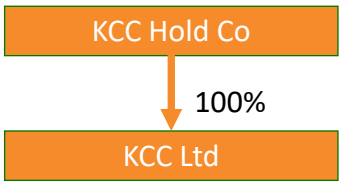
Journal (KCC separate financial statements)

Purchase of the shares (1 March 2022)

Investment in shares	20 000	
Cash		20 000

Recorded price increase (31 December 2022)

Investment in shares	2 500	
Profit on shares		2 500



Buys 100 shares in Hold Co of 200 each(value 225)

Net effect of reduction in cash CU20 000, Increase in investments CU22 500 and profit CU2 500

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Example
Treasury shares continued

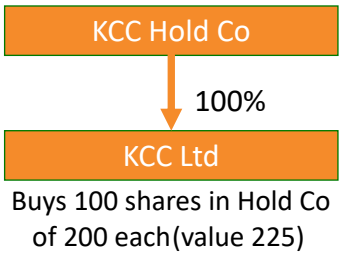
Journal (KCC Hold Co separate financial statements)

Purchase of the shares (1 March 2022)

No journal required

Recorded price increase (31 December 2022)

No journal required



No effect of transaction on KCC Hold Co (it did not receive cash, and it did not issue shares)

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Example
Treasury shares continued

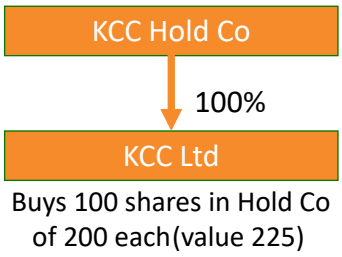
Journal (Consolidated journal entries)

Purchase of the shares (1 March 2022)

Equity (treasury shares)	20 000	
Investment in shares		20 000

Recorded price increase (31 December 2022)

Profit on shares	2 500	
Investment in shares		2 500



Net effect, reduction in Group cash of CU20 000, reduction in group equity of CU20 000

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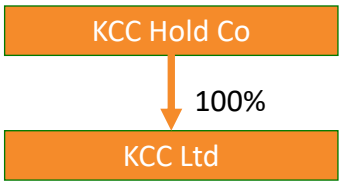
Example
Treasury shares continued

	Invest-ment	Cash	Treasury: Share Capital	Profit
KCC Ltd	22 500	-20 000	-	-2 500
KCC Hold co	-		-	-
Consolidation	-22 500		20 000	2 500
AFS	-	-20 000	20 000	-



Buys 100 shares in Hold Co of 200 each(value 225)

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IFRS 9 *Financial Instruments*
Derivative assets and liabilities

- A financial instrument with all three of the following:
  - its value changes in response to changes in a specified (underlying) variable
  - it requires no or a relatively small initial net investment and
  - it is settled at a future date.
- In most circumstances, measured at fair value

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Example

» What is typically profit or loss from a financial instrument?

Source of income	Yes/No
1. Dividends	
2. Fee income	
3. Fair value profits or losses	
4. Revenue from customers	
5. Interest income	
6. Interest expense	
7. Depreciation	

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Comprehensive Income

» Interest, dividends, losses, and gains on a financial liability are expense or income.

» Distributions on equity instruments are debited directly to equity

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Classification and measurement of financial instruments

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Financial Assets
Classification process

Test

Cash flow characteristics
Solely principal and interest

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Financial Assets
Cash flow characteristics assessment

- If cash flows solely Principal and Interest (SPPI), measurement depends on the business model
- Interest is consideration received for time value of money and credit risk
- Principal is value of the contract at inception
- Standard provides guidance on application of the principle when:
  - Interest rate is leveraged,
  - There is an 'interest rate mismatch',
  - Regulated rates
  - Compensation for prepayment (breakages)

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Sources of information

- Terms and conditions of the financial instrument
- Context of instrument (bespoke or 'off the shelf')
- Legal and customary framework within which the contract is concluded
- Side agreements, umbrella agreements and other contextual arrangements

Consider: reviewing wording of contracts before conclusion

Beware: Intercompany agreements

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Example
Solely payments of Interest and principal test (SPPI)

KCC invests excess money in Macedonian 364 day treasure bills

» Auctioned on 25 Jan 2023

» Treasuries issued at auction at 91.473 per 100

» There are no interest coupons

» Implied rate is 9.437%

» Full nominal amount paid out on 24 Jan

Do the treasury bills meet the SPPI test?

A) Yes, B) No

Paragraph B4.1.13 of IFRS 9

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Example
Contractual cash flow characteristics

KCC holds USD in 12 month bank deposits.

» The deposits pay a 12-month USD market rate.

» However, the entity can withdraw funds with 30 day notice.

» If notice is served, the interest rate is retrospectively corrected to reflect actual period of deposit

» The negative adjustment to interest is deducted from amount due

Does this meet the SPPI test?

A) Yes, B) No

Paragraph B4.1.13 of IFRS 9

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Example
Contractual cash flows

» KCC makes loans to its staff

» Market interest rate is 10%, staff loans are advanced to eligible staff at 5%

» Loans are repayable in 60 equal monthly instalments

» There is no penalty for early repayment

» Loan repayments are deducted directly from staff salary

Does this meet the SPPI test?

A) Yes, B) No

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Example
Contractual cash flows

» KCC sells equipment on credit for repayment over 5 years

» The debtor Interest is charged market related interest rates

» If debtors misses two payments, the equipment is repossessed

» Repossessed equipment is valued and sold at KCCs' second hand equipment store

» Debt is reduced by the value of the repossessed equipment\

» KCC usually forgives any remaining debt

Does this meet the SPPI test?

A) Yes

B) No

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Example
Contractual cash flows

» KCC makes loans to its suppliers (farmers)

» Market interest rate is 10%, and loans are advanced at 10%

» Loans are repayable at end of harvest season

» Loans are repayable in a fixed quantity of harvested coffee beans

Does this meet the SPPI test?

A) Yes

B) No

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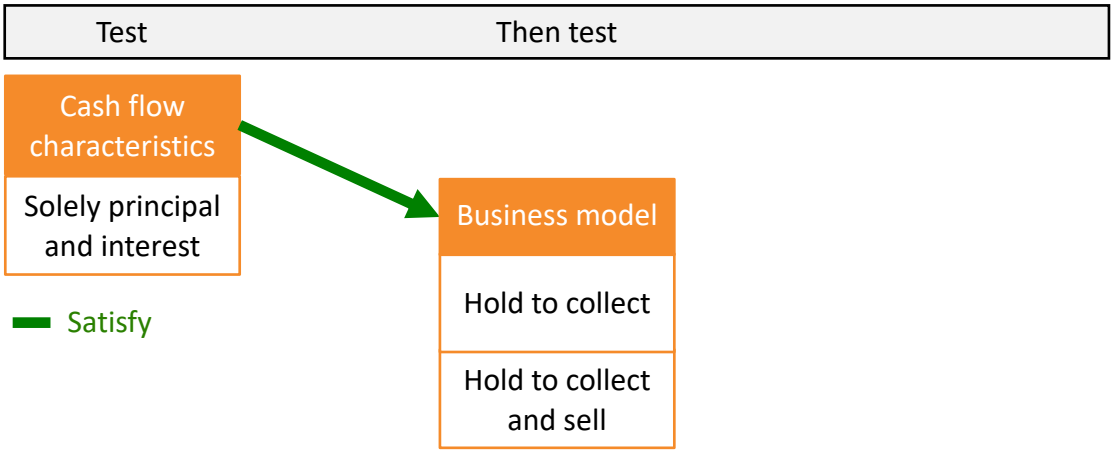
Financial Assets
Classification process



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Business model test

- Hold to collect
  - Objective of holding instruments is to collect contractual cash flows rather than to sell
- Hold to collect and sell
  - Objective of holding instruments is to:
    - collect contractual cash flows; and
    - Sell financial assets
- Not an instrument by instrument approach

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Sources of information

- Internal documentation
  - Reporting performance internally
  - Risk management documentation and limits
  - Compensation determinants for management, and
  - Other indicators, such as budgets and past practice

Consider: do your documented processes represent practice

Beware: incremental or event driven deviations from process

Note: not comparable – dependent on entity objectives

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Example
Business model test

» KCC makes loans to its staff

» KCC considers that these loans improve staff morale and retention

» It collects the loans over the contractual period of the loans, unless the staff member resigns

» If the staff member resigns, the loan is either:

  » repaid immediately, or

  » taken over by a local bank (the loan has a clause allowing the bank to reset the interest rate to market)

What is the business model?

A) Hold to collect, B) hold to collect and sell, C) other

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Example
Business model test

» KCC holds treasury bills to collect contractual cash flows

» It has risk management activities for credit and liquidity

  » sales have typically occurred when assets' credit risk has increased (credit criteria no longer met)

  » Some sales occur for unanticipated funding needs

» Reports to key management focus on contractual return.

» KCC monitors fair values of assets among other information

What is the business model?

A) Hold to collect, B) hold to collect and sell, C) other

Example 1, Paragraph B4.1.4 of IFRS 9

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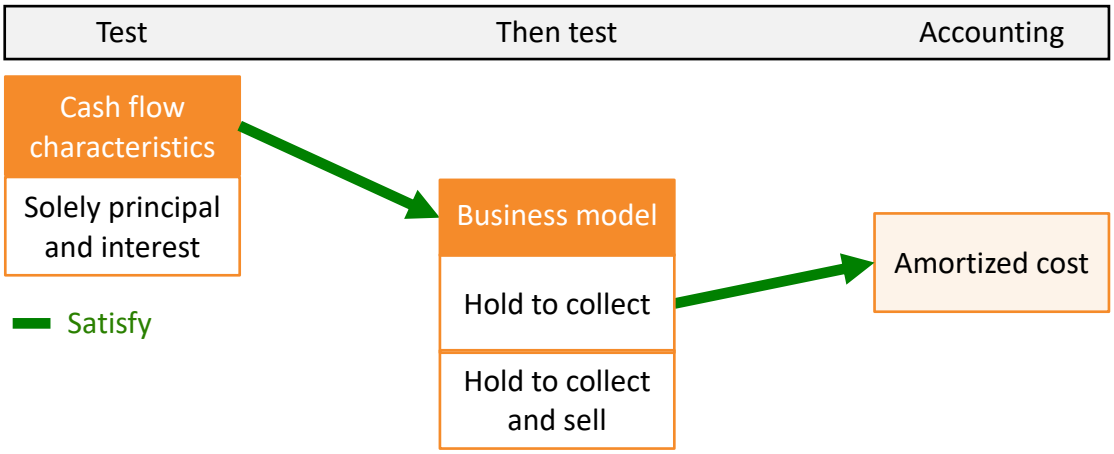
Financial Assets
Classification process



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Amortised cost measurement

- Initial measurement is at fair value plus or minus directly attributable transaction costs
  - However, if an entity originates a loan at an off market rate, and receives an upfront fee as compensation, then that fee is part of interest
- Measurement is based on the effective interest rate method
- Allocation of interest over time is also based on the effective interest method
- An asset is impaired applying IFRS 9 impairment

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Sources of information

- Typically limited to contractual terms,
- Judgements:
  - Transaction costs
  - Fee income that compensates for below market interest
  - Duration
  - Penalties

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Example
Staff loan

- KCC makes a $100 000 loan to a member of staff
- Market interest rate is 10%, staff loans are advanced to eligible staff at 5%
- Loans are repayable in 60 equal monthly instalments of $1 887

Applying amortised cost, what is the day one value of the loan?

A. $100 000 (the amount advanced to the staff member)
B. $88 818 (the present value of repayments discounted at 10%)
C. $113 227 (the sum of 60 payments of $1 887)

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Example staff loan

» KCC makes a $100 000 loan to a member of staff

» Market interest rate is 10%, staff loans are advanced to eligible staff at 5%

» Loans are repayable in 60 equal monthly instalments of $1 887

What is the initial journal entry for the loan?

	Debit	Credit
Dr Loan to staff	88 818	
?		
Cr Cash balance		100 000

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Example
Amortised cost

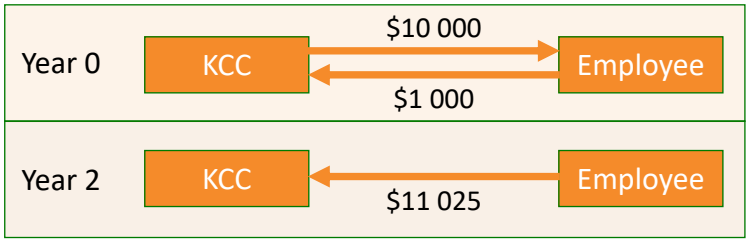
KCC grants a loan to a member of staff:

» Loan amount is $10 000

» Loan bears interest at 5% per year

» Staff member pays $1 000 as an origination fee, on loan grant

» Loan repayable in single instalment of $11 025 in 2 years time



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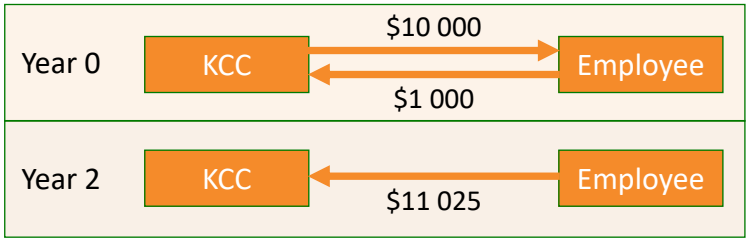
Example
Amortised cost

» What is the effective rate of interest:



	1	2	3
Loan (day 0)	10 000	9 000	10 000
Repayment (24 months)	11 025	11 025	12 025
Effective interest rate	5.0%	10.7%	9.7%

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Example
Amortised cost – journal entries

Initial	Debit	Credit
Dr Loan to staff	9 000	
Dr Cash balance (receipt from staff)	1 000	
Cr Cash balance (payment to staff)		10 000
Dr Loan to staff	964	
Cr Interest received (year 1)		964
Dr Loan to staff	1 061	
Cr Interest received (year 2)		1 061

Loan of $9 000 + interest of $964 and $1061 = closing balance $11 025

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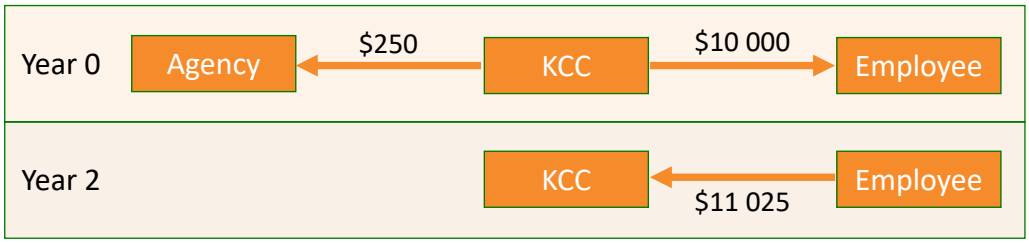
Example
Amortised cost

KCC grants a loan to a member of staff:

- Loan amount is $10 000
- Loan bears interest at 5% per year, market rate is 5%
- Loan repayable in single instalment of $11 025 in 2 years time
- Entity pays $250 fee to credit agency, not recovered from staff



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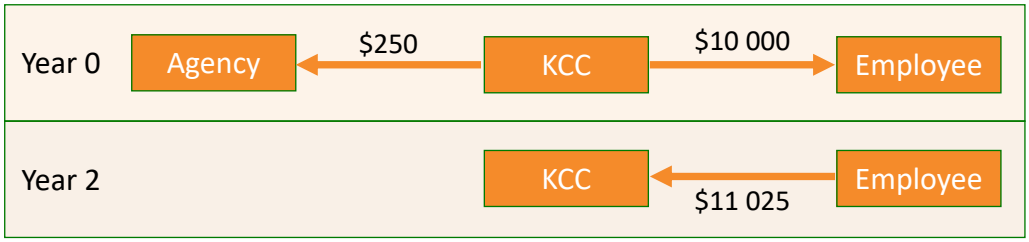
Example
Amortised cost

- What is the effective rate of interest:



	1	2	3
Loan (day 0)	10 000	10 250	10 000
Repayment (24 months)	11 025	11 025	10 775
IRR	5.0%	3.7%	3.8%

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Example
Calculating Internal rate of return with excel

	A (description)	B (cash flows)
1	Begin year 1	(10 250)
2	End year 1	0
3	End year 2	11 025
4		3.7%

Using Excel to calculate internal rate of return

Cell B4 contains: =IRR(B1:B3)

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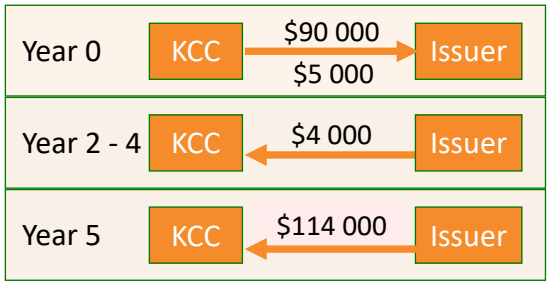
Example
Amortised cost

- KCC buys a $100 000 treasury bond on issue,
  - cost is $90 000,
  - directly attributable transaction costs $5 000.
  - bond is redeemable at $110 000, in 5 years, and
  - Pays $4 000 interest annually (4%)



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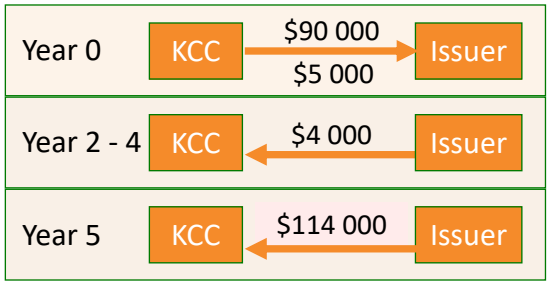
Example
Amortised cost

» What is the initial balance of the the bond instrument?

1) 90 000
2) 95 000
3) 100 000
4) 114 000?



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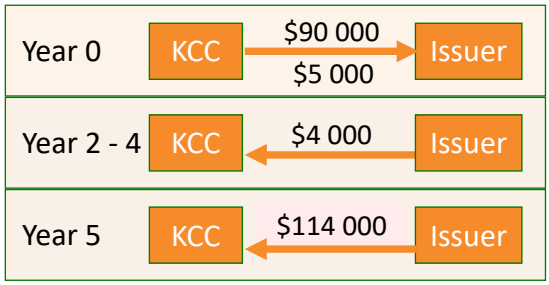
Example
Amortised cost

» What is the initial balance of the the bond instrument?

1) 90 000
2) 95 000
3) 100 000
4) 114 000?



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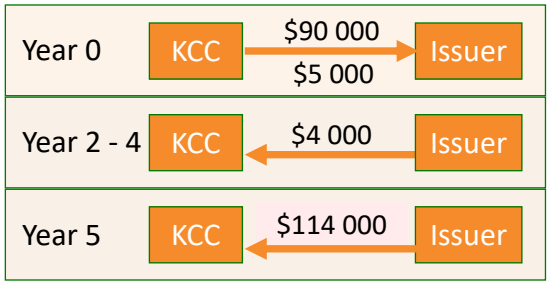
Example
Amortised cost

» What is the effective interest rate on the bond?

1) 4% (4 000 over 100 000)
2) 4.2% (4 000 over 95 000)
3) 6% (20 000 + 10 000 over 100 000) for 5 years
4) Something else



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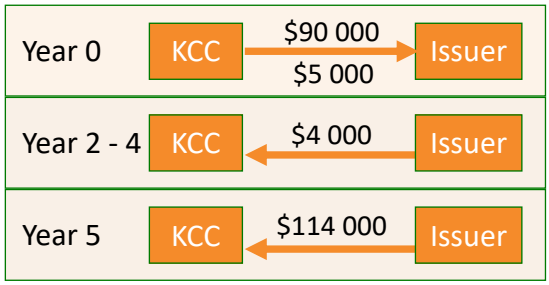
Example
Amortised cost

» KCC buys a treasury bond on issue,
- » cost is $90 000,
- » directly attributable transaction costs $5 000.
- » bond is redeemable at $110 000, in 5 years, and
- » Pays $4 000 interest annually (4%)



» At end of 3rd year, drop in interest rates causes fair value of the asset to change to $106 000

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Example
Amortised cost

» At end of year 3, the calculated closing balance is $103 389

» The fair value is $106 000

What adjustment do you make under the amortised cost approach?

A. Increase closing balance to $106 000

B. Decrease closing balance to $103 389

C. No change

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Example
Calculating annual interest

Yr	Opening balance	Interest @ 6.958%*	Sub-total	Cash inflow	Closing balance
X1	95 000	6 611	101 611	(4 000)	97 611
X2	97 611	6 792	104 403	(4 000)	100 403
X3	100 403	6 986	107 389	(4 000)	103 389
X4	103 389	7 194	110 583	(4 000)	106 583
X5	106 583	7 417	114 000	(114 000)	0

* Internal rate of return = effective interest rate

Amortised cost, therefore increase in fair value is not accounted for

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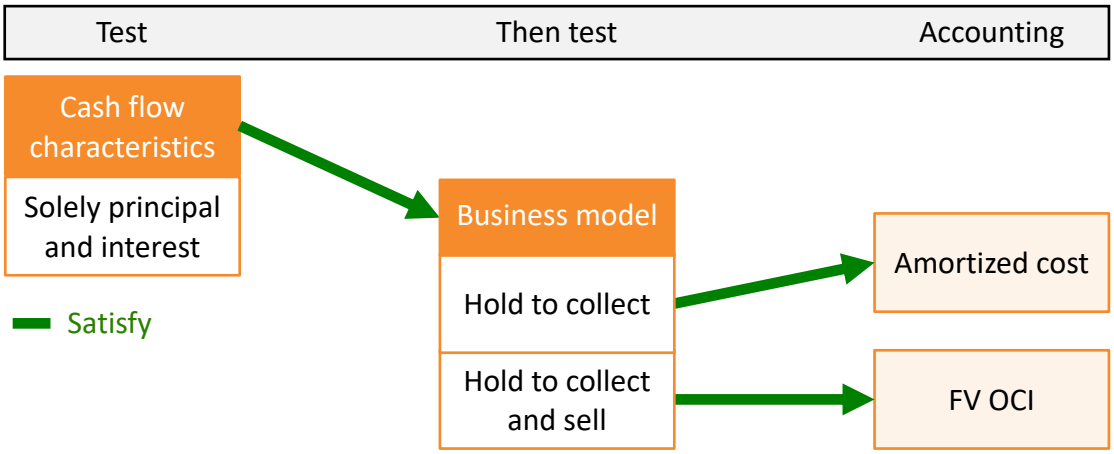
Financial Assets
Classification process



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Fair value OCI

» Initial recognition is the same as amortised cost

» Subsequent balance sheet measurement is at fair value

» Income statement measurement based on the effective interest rate method (same as for amortised cost)

» Difference in value methodologies is taken to OCI

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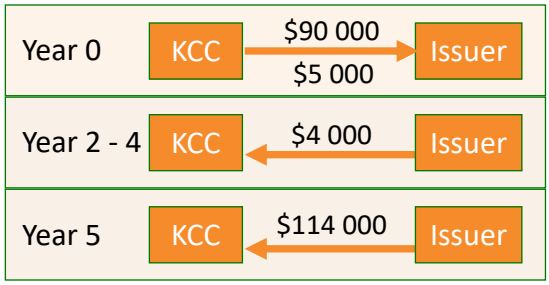
Example
Fair value through OCI

- KCC buys a treasury bond on issue,
  - cost is $90 000,
  - directly attributable transaction costs $5 000.
  - bond is redeemable at $110 000, in 5 years, and
  - Pays $4 000 interest annually (4%)



- At end of 3rd year, drop in interest rates causes fair value of the asset to change to $106 000

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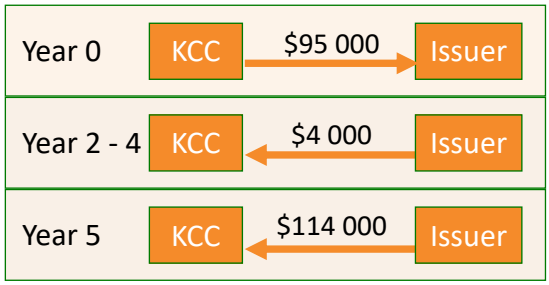
Example
Calculating Internal rate of return

	A (description)	B (cash flows)
1	Begin year 1	(95 000)
2	End year 1	4 000
3	End year 2	4 000
4	End year 3	4 000
5	End year 4	4 000
6	End year 5	114 000
7		6.958%



Cell B7 contains: =IRR(B1:B6)

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Example
Calculating annual interest

Yr	Opening balance	Interest @ 6.958%*	Cash inflow	OCI	Closing balance
X1	95 000	6 611	(4 000)		97 611
X2	97 611	6 792	(4 000)		100 403
X3	100 403	6 986	(4 000)		103 389
X3	Fair value changes to:				106 000

?

* Internal rate of return = effective interest rate

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Example
Amortised cost

» At end of year 3, the calculated closing balance is $103 389

» The fair value is $106 000

What adjustment do you make under the FVOCI approach?

A. Increase closing balance to $106 000

B. Decrease closing balance to $103 389

C. No change

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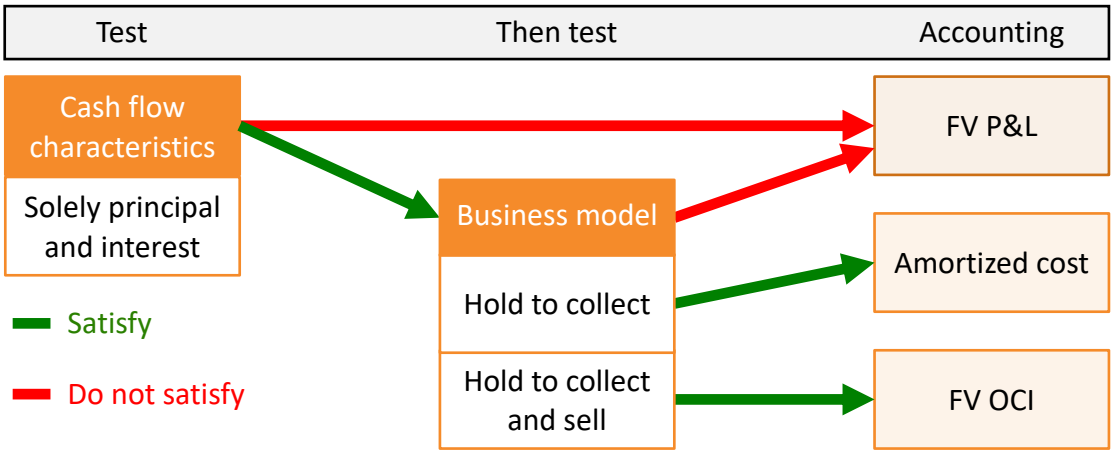
Financial Assets
Classification process



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Financial Assets
Classification process - options

Accounting	Allowed options	Restrictions
FV P&L	Equities through OCI, not trading	Irrevocable No recycling
Amortized cost	FV for accounting mismatch	Irrevocable
FV OCI		

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Reclassifications

Financial Assets

- When, and only when, an entity changes its business model for managing financial assets
- Expected to be very infrequent
- Changes must be significant to entity's operations and **demonstrable** to external parties
- Date is 1st day of 1st reporting period following change

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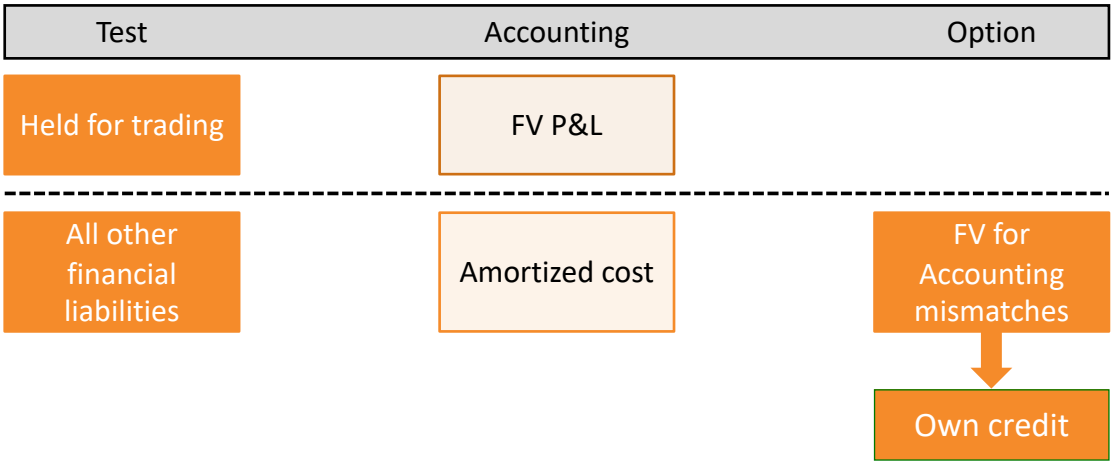
Financial Liabilities
Classification process



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Financial Liabilities
Own credit

» P&L gain when 'own credit' deteriorates, loss when it improves

Balance Sheet	Comprehensive Income
Fair value liability: All changes including own credit	P&L: all changes except own credit OCI: changes in own credit

» Required by IFRS 9 for liabilities under the FVO

» Corrects for counter-intuitive effect

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Financial Liabilities
Own credit

» KCC issues $100m debt on a traded capital market

» KCC is rated AAA - debts trades at nominal value ($100m)

» Mgt uses $70m to speculate but makes unrealised losses of $35m

» Ability to repay debt is compromised - fair value of debt is $60m

» If the debt is carried at fair value, the Journal entries are:

Dr/(cr)	Journal	Opening balance	Journal effect	closing balance
Dr FV Liability	40.	(100)	40.	(60)
Cr Comprehensive income	(40)	-	(40)	(40)

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Aims

- Deepen your understanding of IFRS 9 impairment
  - Scoping
  - Deterioration model
  - Simplified model

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Impairment of financial instruments

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Objective

» Credit margin on financial instruments should reflect initial credit loss expectations

» When expected credit losses increase, an economic loss is suffered because credit margin is insufficient

» IFRS 9 reflects this by measuring impairment considering changes from inception

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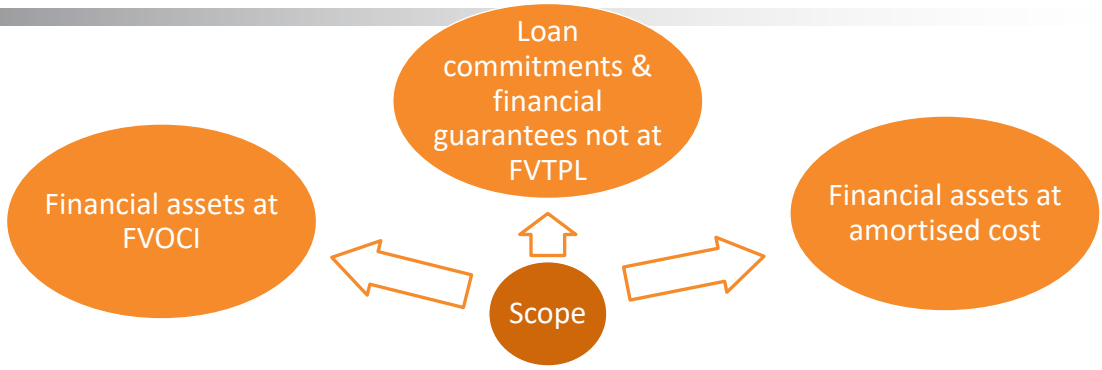
Scope



Supplier loans Staff loans Bank balances	Trade receivables Lease assets

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Deterioration model

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Overview of the model

Credit quality deterioration since initial recognition

Impairment recognition	12 month expected loss	12 month PD x LGD
Interest revenue	Gross basis	Balance x EIR
Stage 1 *Performing*		

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Sources of information

- Pricing data (how was the product priced)
- Internal credit ratings
- External credit ratings
- Historical experience with clients
- Macro indicators:
  - Data from central bank
  - Data from world bank
  - Data from rating agencies

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Example
Some important terms

- Probability of default: the likelihood that a debtor will default on its obligations in a defined future period
- Default: Debtor has reneged on its obligations, usually by missing a payment but may also be missed debt covenants, liquidation etc
- Loss given default: How much you expect to lose if a debtor defaults
- Exposure at default: How much will you be owed when debtor defaults (for revolving credit such as store cards or overdraft, usually the maximum debt limit)

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Example
Loss given default

- KCC holds a USD deposit with the US Import/export bank
- Deposit is underwritten by a US government guarantee of the nominal amount
- On default, US government takes 12 months to settle guarantee
  - USD Interest rate is 6%,
  - Nominal amount is $1 million
  - Assume US government default risk is negligible
- Calculate the ***loss given default***
- A) $1 000 000, B) Nil, 3) $56 600, D) $60 000

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Example
Collateralised assets

- KCC has fully collateralised financial assets with no default history. How can it determine the LGD percentage?
- Are these assets not subject to ECL?
- Is it allowed to use the minimum Basel category?
- Is discounting to present value the only option to determine the default?

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Example
Explicit probability of default

» KCC granted a 3 year loan of $1 million to a large farm group

» KCC estimates a:

» 12 month probability of default (PD) at origination of **5%** and

» a loss given default (LGD) of **25%**

» At year end, balance, PD and LGD are unchanged

» What impairment loss does KCC recognise?

1	2	3	4
$50 000	$250 000	$12 500	$Nil
$1m x 5%	$1m x 25%	$1m x 5% x 25%	No change = nil

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Example
Loan commitment

» KCC enters bridging finance arrangement with supplier:

» It agrees supplier can borrow up to a maximum of $10m,

» At a market related interest rate of 11%

» Amount borrowed repayable over 5 years from date of drawdown

» Facility is in place for 5 years and cannot be withdrawn

» At yearend, no draw down, 12 month probability of default was 5%, LGD was 50%, EAD 100%, no significant change

» What provision is required under IFRS 9?

A) 0, B) $500 000, 3) $250 000

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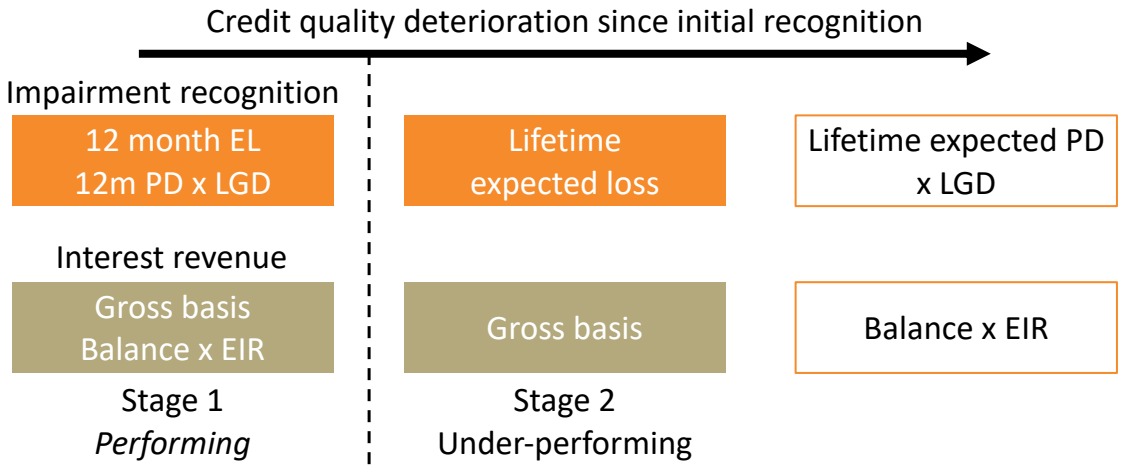
Overview of the model



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Sources of information

As before plus

» Delinquency information

» Publicly available information such as press reports, financial statements etc

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Example
Assessing significant increase in credit risk - unanticipated

» Entity A provides a loan facility to a supplier manufacturer

» At the time of origination of loan:

» expected supplier would meet loan covenants

» stable expected revenue and cash flow in the industry

» Subsequent:

» supplier underperforms on its business plan

» Supplier is close to breaching its covenants

» Entity expects further deterioration in economic environment

Has there been a significant increase in credit risk?

A) Yes, B) No

IFRS 9 Illustrative example 1

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Example
Assessing significant increase in credit risk - anticipated (1 of 2)

» Co C is parent of group operating in cyclical industry

» Group structure complex, subject to change, investors struggle to analyse expected performance and forecast cash flows

» Bank B provided loan to C when prospects are positive

» However, a potential decrease in sales was anticipated

» At the time that Bank B originates the loan:

» Creditors concerned about C's ability to refinance its debt.

» C's leverage in line with other customers with similar risk

» Headroom on its coverage ratios high

IFRS 9 Illustrative example 2

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Example
Assessing significant increase in credit risk - anticipated (2 of 2)

» B determines on initial recognition that loan is subject to considerable credit risk and has speculative elements

» Subsequent to initial recognition, C announces significant reduction in sales volume in some subsidiaries but expects improvement in following months.

» C announces a corporate restructure, which will increase flexibility to refinance existing debt and the ability of the subsidiaries to pay dividends to C.

Has there been a significant increase in credit risk?

A) Yes, B) No

IFRS 9 Illustrative example 2

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Example
Impairment provision

» Entity A grants a loan to Investment authority

» Loan has no repayment conditions, no date of maturity but accrues interest. On liquidation, loan becomes payable immediately

» Entity considers current financial situation of IA and concludes the re is a **10%** probability IA will be liquidated within next 12 months

» Outstanding loan at yearend is $1 million plus accumulated interest of $125 000

» Loss given default is **50%**.

Provision is: *A) 1 125 000, B) 562 500, C) 56 250?*

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Example
Assessing significant increase in credit risk - collateral

» Entity provides home loans to employees
  » Staff have to pay a minimum of 25% in cash deposit
  » Entity takes a mortgage over the property
» Subsequent to initial recognition:
  » Difficult economic situation in country means increases are frozen, and bonusses reduced to zero
  » This creates some payment difficulties for employees
» Value of properties remain well above loan amounts

Is there a significant increase in credit risk? A) Yes, B) No

IFRS 9 Illustrative example 3

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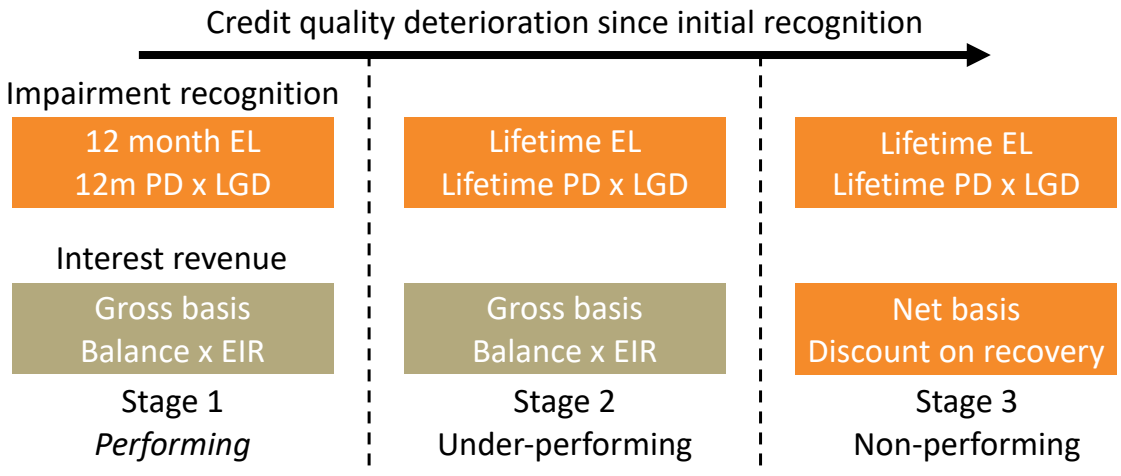
Overview of the model



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Expected credit losses

Credit loss - difference between all contractual cash flows owing to entity and all cash flows it expects to receive, discounted at original effective interest rate

Expected credit losses (ECL) - risk of default weighted average of credit losses

What are 12-month ECL?	What are lifetime ECL?
ECL representing lifetime cash shortfalls if default occurs in 12 months weighted by probability of that default occurring	ECL that result from all possible default events over the expected life of a financial instrument

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Expected credit losses
When to recognise

When to recognise 12-month expected credit losses?

- No significant increase in credit risk since initial recognition; or
- Low credit risk (for example, 'investment grade')

When to recognise Life time expected credit losses?

- Underperforming assets, significant increase in credit risk since initial recognition
- Non-performing assets, ie asset is credit-impaired

Expected credit losses will be recognised for all financial instruments in scope at all times

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Determining significant increase in credit risk

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Significant increase in credit risk

» Change in credit risk over life of instrument (risk of a default)
  » Default not defined (rebuttable presumption 90 days past due)
» Compare to credit risk at initial recognition
  » reasonable & supportable information, available without undue cost or effort, indicative of significant increases in credit risk
» Financial instruments with low credit risk at reporting date may assume credit risk has not increased significantly
» **Rebuttable presumption** credit risk has increased significantly for loans more then 30 days past due

ECL updated at reporting date for new information even if deterioration is not significant

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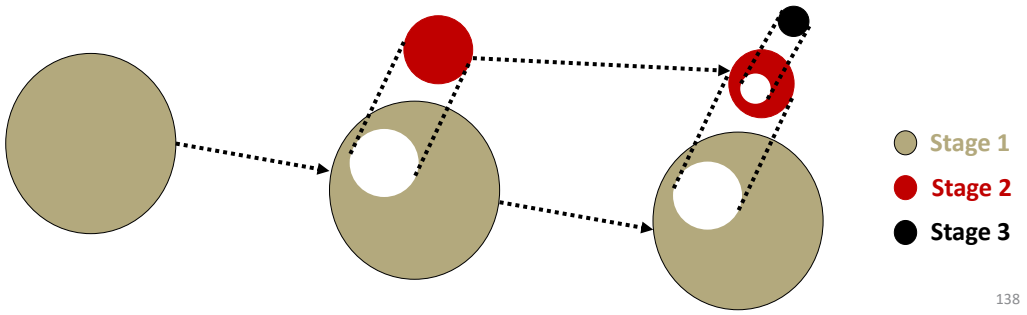
Assess significant increase in credit risk

As information emerges– entity better able to distinguish credit risk of loans

Portfolio of home loans originated in a country	Information emerges that a region in the country is experiencing tough economic conditions.	More information emerges and the entity is able to identify the particular loans that are in default or will imminently default.



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Example
Collective assessment

Bank provides mortgages to finance residential real estate in a specific area

Area includes mining community - largely dependent on export of coal and related products

Significant decline in coal exports occurs and closure of several coal mines expected

Risk of default on loans to borrowers employed by coal mines determined to have increased significantly

IFRS 9 Illustrative example 4

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Credit-impaired financial assets
Evidence

- Significant financial difficulty of the issuer or the borrower
- Breach of contract, eg default or past due event
- Borrower granted a concession that the lender(s) would not otherwise consider
- Probable that the borrower will enter bankruptcy or other financial reorganisation
- Disappearance of an active market for that financial asset because of financial difficulties
- Purchase or origination of a financial asset at a deep discount that reflects the incurred **credit losses**

Single event or combined effect of several events

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Example
Regulations vs IFRS

» Bank A is regulated by the central bank

» **Applying IFRS 9**, Bank A calculates its impairment provision as $1,000,000

» **Applying the central bank** impairment framework, Bank A determines an impairment provision of $1,500,000

How should Bank A account for impairments in its IFRS financial statements?
Assume tax rate is zero

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Example
Regulations vs IFRS

How should Bank A account for impairments in its financial statements?

» To be IFRS compliant, Bank A applies IFRS 9 to calculate impairment provision recorded in Financial statements:

	IFRS Accounts	Prudential
Impairment provision	1 000 000	1 500 000

» Then Either:

» Create an equity reserve, or

» Disclose reconciliation between equity for IFRS and prudential capital

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Example
Regulations vs IFRS

Observed practice:

Total equity	Retained income	Prudential reserve
Opening balance	650 000	250 000
Current period income	1 100 000	-
Transfer to prudential reserve	-250 000	250 000
Closing balance	**1 500 000**	**500 000**
Prudential Retained income	**1 500 000**	**-**

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Assess significant increase in credit risk
Collective and individual assessment basis

- Use relevant, reasonable and supportable forward-looking information available without undue cost or effort to assess changes in credit risk
- If no reasonable and supportable information is available without undue cost or effort on an individual instrument basis – consider measurement on a collective basis
- Grouping financial instruments for collective assessment – examples of shared credit risk characteristics:
  - instrument type, credit risk ratings, collateral type, date of initial recognition, remaining term to maturity, industry, geographical location of the borrower etc

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Significant increase in credit risk
Absolute Vs Relative Changes

- The impairment model is based on an assessment of changes in credit risk since initial recognition, rather than the identification of a specific level of credit risk at the reporting date; and
- A smaller absolute change in the risk of default occurring will be more significant for an asset that is of high quality on initial recognition than for one that is of low quality.
- It may not be appropriate to always use a single threshold (say credit rating over 5) to determine significant increase - will depend on the credit grading system being used

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Measurement of expected credit losses

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Information set

» Information used to measure expected credit losses and assess changes in credit risk:

- » Available without undue cost or effort
- » Historical, current and *reasonable and supportable forecasts*
- » Ensure historical information is relevant (may need adjustment)
- » Emphasis is on forward looking information, but if nothing more forward looking is available, delinquency information may be used
- » Emphasise that expect to move to stage 2 BEFORE delinquent

Particular measurement methods are not prescribed; nor must PD be explicitly included as an input

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Information set (contd.)

- New information that is reasonable and supportable and becomes available before the reporting date is required to be taken into consideration when applying the impairment requirements.
- Entities need proper processes and appropriate governance procedures for incorporating information in the calculation of ECL, including forecasts of future economic conditions.
- This includes processes for updating expected credit losses for new information that becomes available after the initial modelling has taken place up until the reporting date.
- Materiality considerations apply.

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Reasonable and Supportable

- Include information about past events, current conditions and forecasts of future economic conditions.
- Borrower-specific factors: operating results of borrower, technological advances, changes in collateral supporting obligation
- Macroeconomic factors: house price indexes, GDP, household debt ratios
- The data sources could be internal (credit loss experience and ratings) or external (ratings, statistics or reports)

Historical information can be used as a base but must be updated to reflect current conditions and future forecasts

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Reasonable and Supportable (contd.)

- Objective is to determine expected credit losses by considering all reasonable and supportable information, including forward-looking information, that is relevant and available without undue cost or effort.
- Information with these characteristics is used in both the assessment of significant increases in credit risk and in the measurement of expected credit losses.
- Will require judgement.
- Information should not be excluded simply because:
  - the event has a low or remote likelihood of occurring; or
  - the effect of that event on the credit risk or the amount of expected credit losses is uncertain.

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Forward Looking Scenarios: *Measurement of ECL*

- The measurement of expected credit losses is required to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes.
- Consequently, when there is a non-linear relationship between the different forward-looking scenarios and their associated credit losses, using a single forward-looking economic scenario would not meet this objective.
- More than one forward-looking scenario would need to be incorporated into the measurement of expected credit losses.

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Example
Forward Looking Scenarios: Measurement of ECL (1 of 2)

» 4 per cent future unemployment (which has a 20 per cent likelihood of occurrence) results in expected credit losses of CU30;

» 5 per cent future unemployment (which has a 50 per cent likelihood of occurrence) results in expected credit losses of CU70; and

» 6 per cent future unemployment (which has a 30 per cent likelihood of occurrence) results in expected credit losses of CU170.

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Example
Forward Looking Scenarios: Measurement of ECL (2 of 2)

» If an entity used a single central economic scenario based on the most likely outcome of 5 per cent future unemployment, this would give rise to an expected credit loss of CU70

» However, if the entity used a probability-weighted range of those scenarios, the expected credit loss would be CU92 ((CU30 × 0.2) + (CU70 × 0.5) + (CU170 × 0.3))

» In this example, using a single central forward-looking economic scenario would not result in an unbiased and probability-weighted amount in accordance with IFRS 9

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Forward Looking Scenarios: *Reasonable and supportable*

» A spectrum of forward-looking information available.

» Can be challenging and on occasion difficult to determine the economic consequences (or 'second-order effects') of uncertain future outcomes.

» Entities need to focus on determining the economic consequences (or 'second-order effects') of uncertain future outcomes.
  » Eg, while it may be possible to assess the likelihood of particular event occurring, it may be difficult to determine effect of event on risk of a default occurring and/or on credit loses that would be associated with that event using reasonable and supportable information.

» **Avoid double counting.**

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Forward Looking Scenarios: *Determining SICR*

» When there is a non-linear relationship between the different forward-looking scenarios, using a single forward-looking scenario as a basis for this assessment would not meet the objectives of IFRS 9.

» There should be consistency, to the extent relevant, between the forward-looking information used for the measurement of expected credit losses and for the assessment of significant increases in credit risk.

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Measurement

ECL measured in a way that reflects:

» Unbiased and probability-weighted outcome: must consider possibility that credit loss will/will not occur

» Time value of money – discount at EIR or an approximation thereof

» Reasonable and supportable information: available without undue cost or effort at the reporting date, reflecting:

Past events + Current conditions + Future economic conditions

Particular measurement methods are not prescribed

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Measurement

» Estimates of expected credit losses should reflect an entity's own expectations of credit losses;

  » Entities should be able to explain how they have arrived at their estimate and how it is based on reasonable and supportable information.

» Consider market information

» Expected credit losses are estimates, which will be updated as more reasonable and supportable information becomes available over time.

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Loan commitments and financial guarantee contracts

Apply general impairment model

- Credit risk managed in same way so same model
- Have a **present legal obligation** to extend credit
- Generally longest period considered to measure expected losses is contractual period exposed to credit risk
- Exception is for facilities where **consider term beyond contractual period** during which exposed to credit risk and would not be mitigated by credit risk management actions
- Estimate usage behaviour

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Example
Loan commitment

- Entity A enters bridging finance arrangement with supplier:
  - It agrees supplier can borrow up to a maximum of $10m,
  - At a market related interest rate of 11%
  - Amount borrowed repayable over 5 years from date of drawdown
  - Facility is in place for 5 years and cannot be withdrawn
- At yearend, outstanding loan amount was $0, 12 month probability of default was 5%, LGD was 50%, EAD 100%, no significant change
- What provision is required under IFRS 9?

A) 0, B) $500 000, C) $250 000

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Credit-impaired on initial recognition

- Applies to *originated* and *purchased* credit-impaired financial assets
- Always outside the general model
- Use *credit-adjusted effective interest rate*
  - No day 1 allowance balance
  - No day 1 impairment loss recognised
- Allowance balance always represents *changes* in lifetime credit loss expectations

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Significant judgements

- Determining if there is a significant increase in credit risk
- Measurement of expected credit losses (ECL)
- Determining whether loans will be paid as due – and, if not, how much might be recovered and when
- Probability-weighting different scenarios
- Appropriately incorporating forward-looking information into the assessment of changes in credit risk and measurement of ECL
- Determining whether a collective or individual assessment is needed for portfolios of shared risk characteristics

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Disclosures (IFRS 7)

Objective: enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows	
Quantitative	Qualitative
Reconciliation of allowance accounts showing key drivers for change	Basis of inputs, assumptions and techniques used to: • measure 12-month and lifetime ECL • determine 'significant increase in credit risk' • determine 'credit-impaired'
Explanation of gross carrying amounts showing key drivers for change	How forward-looking information has been incorporated
Gross carrying amount by *credit risk rating grades*	Changes in estimation techniques or significant assumptions made and reasons for changes

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Disclosures (IFRS 7)

Objective: enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows	
Quantitative	Qualitative
Max exposure to credit risk (net of collateral) and collateral for credit impaired assets	Basis for grouping if expected credit losses were measured on a collective basis
Modification to contractual cash flows	Entity's default definition and reasons for selecting those definitions
Contractual amount outstanding for assets written off but still subject to enforcement activity	Write off policies, modification policies, collateral

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Simplified impairment requirements

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Mandatory in Scope

Trade receivables or contract assets from transactions that are in scope of IFRS 15

- that do not contain a significant financing component, **or**
- where the entity applied the IFRS 15 practical expedient not to adjust for significant financing , and
- entity expects at inception that the credit period will be one year or less

[A significant financial component exists] if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. (IFRS 15.60)

IFRS 9.5.5.15 and IFRS 15.60 and 63

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Example
Loans to suppliers

» KCC makes agricultural loans to suppliers

» The loan bears interest at 10% per annum (market related)

» The loan is repayable in full after harvest (less then one year)

Does the loan fall under the mandated simplified approach?

A. Yes, it is less then one year

B. No, IFRS 15 does not apply

C. Depends whether optional expedient is applied

D. KCC can choose

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Example
Sales on credit to suppliers

» KCC sells coffee beans to local coffee shops

» It provides interest free credit up to 120 days

» KCC elects to apply the practical expedient not to adjust for significant financing

Does the credit fall under the mandated simplified approach?

A. Yes, it is less then one year

B. No, IFRS 15 does not apply

C. KCC must apply the simplified approach

D. KCC can choose

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Example
Sales on credit to suppliers

» KCC sells coffee beans to local coffee shops

» It provides interest free credit up to 120 days

» KCC elects to apply the practical expedient not to adjust for significant financing

Does the credit fall under the mandated simplified approach?

A. Yes, it is less then one year

B. No, IFRS 15 does not apply

C. KCC must apply the simplified approach

D. KCC can choose

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Optional in Scope

Accounting policy choice:

» Trade receivables or contract assets from transactions that are in scope of IFRS 15, and contain a significant financing component

» Lease receivables from transactions that are in scope of IFRS 16

» Accounting policy choice can be separately applied for each type of asset (but applies to all assets of a particular type)

IFRS 9.5.5.15

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Example
Loans to suppliers

» KCC makes agricultural loans to suppliers

» The loan bears interest at 10% per annum (market related)

» The loan is repayable in full after harvest (less then one year)

Is the loan eligible for the simplified approach?

A. Yes, it is less then one year

B. No, Neither IFRS 15 nor IFRS 16 apply

C. Depends whether optional expedient is applied

D. KCC can choose

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Example
Sales on credit to suppliers

» KCC sells manufacturing equipment to farmers

» It provides a 5 year instalment loans for the equipment

Is the loan eligible for the simplified approach?

A. Yes, it is less then one year

B. No, IFRS 15 does not apply

C. KCC must apply the simplified approach

D. KCC can choose to apply the simplified approach

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Measurement

- Requires or allows entities to always measure the loss allowance as lifetime expected losses
- An example of an allowed method is a provision matrix:
  - Use historical credit loss experience (**adjusted** as appropriate for current events)
  - specify fixed provision rates depending on the number of past due
  - depending on diversity of loss patterns for different customer segments an entity would **use appropriate groupings**

IFRS 9.5.5.15 and IFRS 9.B5.5.35

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Questions

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