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IFRS 9/ Financial Instruments

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Overview

- Developed by the International Accounting Standards Board (IASB) to replace IAS 39 Financial Instruments: Recognition and Measurement.

- A three-phase project, namely:
  - Classification and Measurement
  - Impairment
  - Hedge Accounting.

Effective for annual periods beginning on or after 1 January 2018 with early application permitted.

Introduction

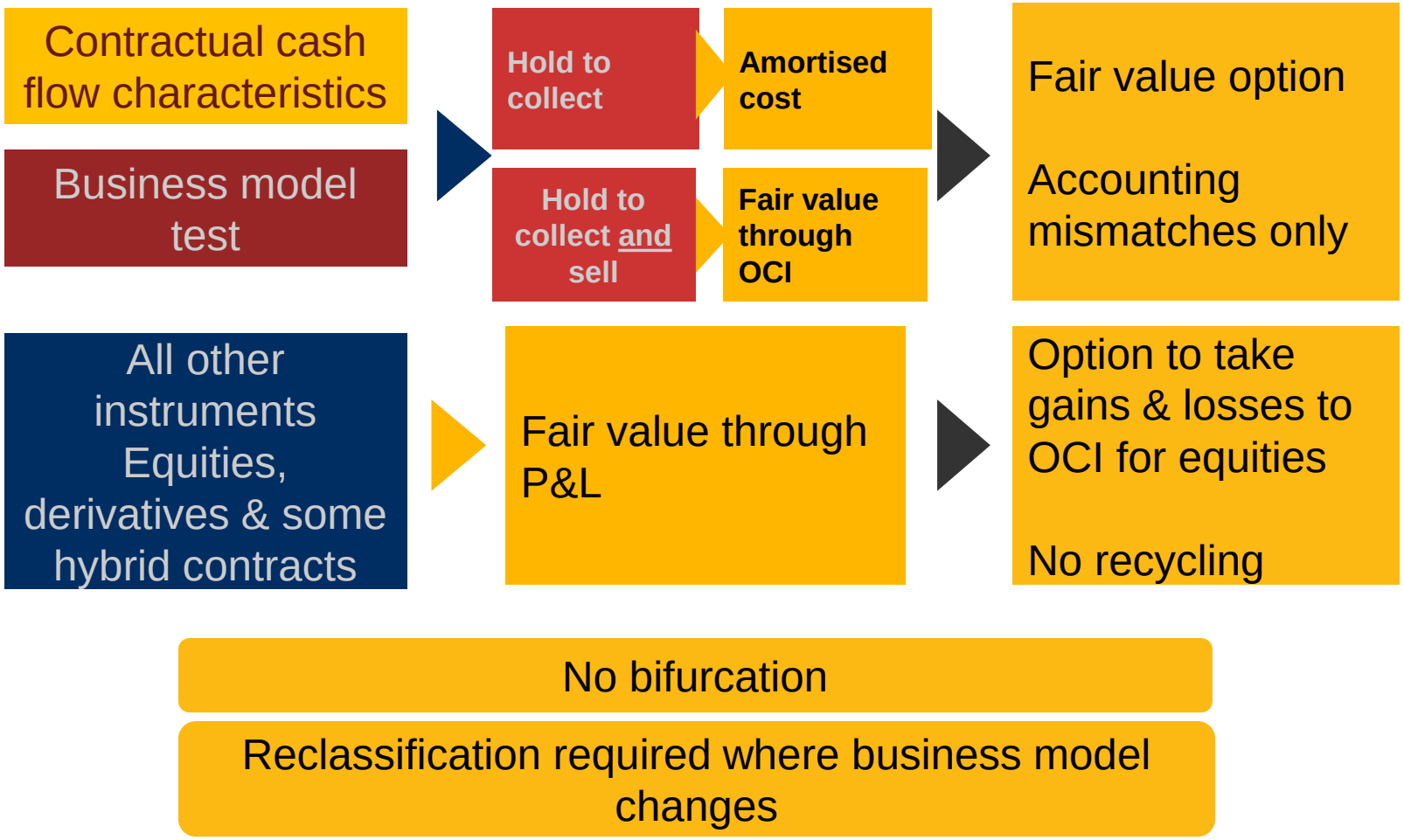
IFRS: International Financial Reporting Standards, usually called IFRS are standards issued by the IFRS Foundation and the International Accounting Standards Board (IASB) to provide a common global language for business affairs so that company accounts are understandable and comparable across international boundaries

The International Accounting Standards Board (IASB) has issued the final version of IFRS 9 that incorporates new regulation on the accounting for financial instruments.

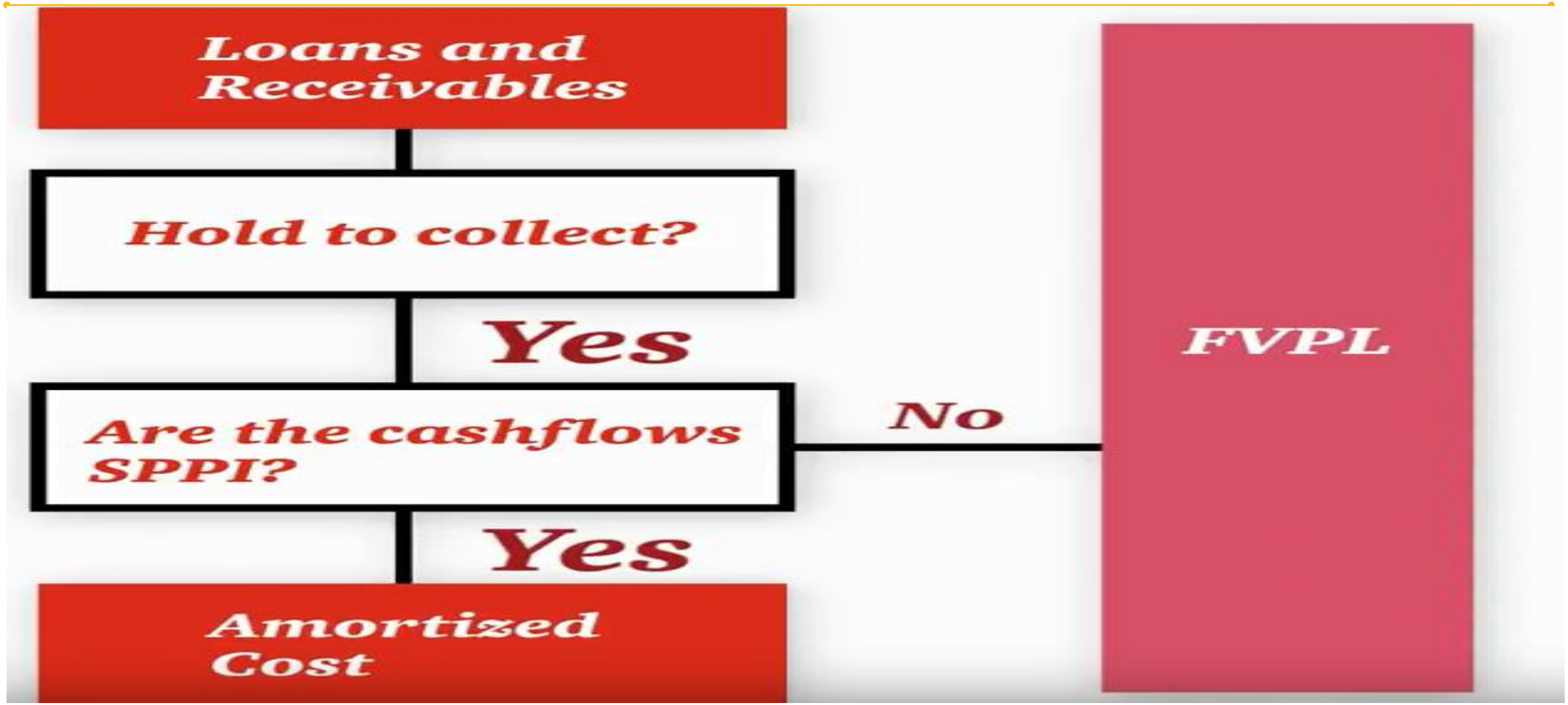
Assets classification

Basis of classification	IAS 39	IFRS 9
Financial assets	• financial assets at fair value through profit or loss; • held-to-maturity investments; • available-for-sale financial assets.	Classification based on: 1. business model 2. the contractual cash flow characteristics
Financial liabilities	• Financial liabilities at fair value through profit or loss • Other financial liabilities measured at amortised cost	

Financial assets – new model summary



Financial assets – new model summary



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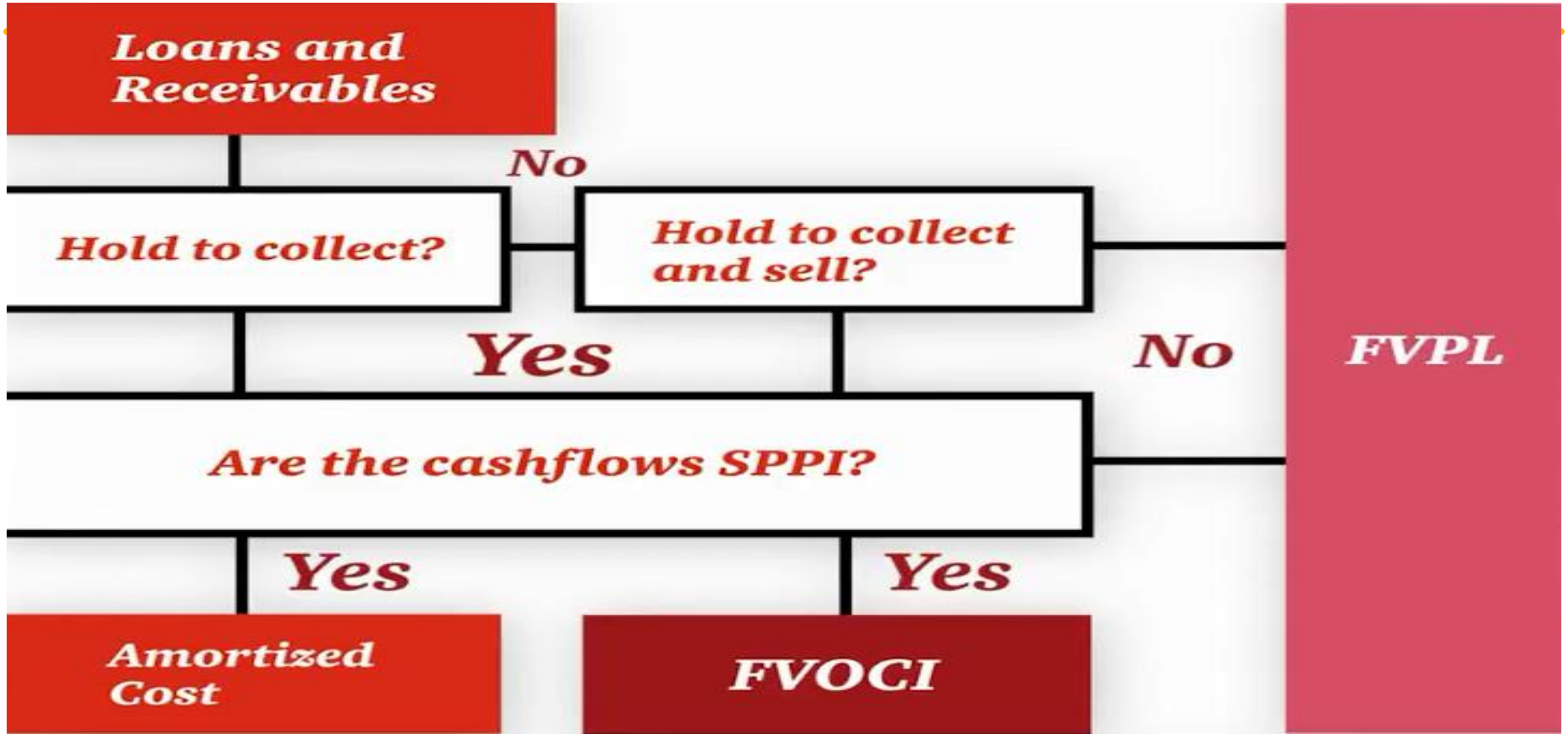


Financial assets – new model summary

Challenges of IAS 39

Too complex,

Inconsistent with the way entities manage their businesses and risks.

defers the recognition of credit losses on loans and receivables until too late in the credit cycle.

Too little
Too late

Phase II: Impairment
Comparison between IAS 39 and IFRS 9

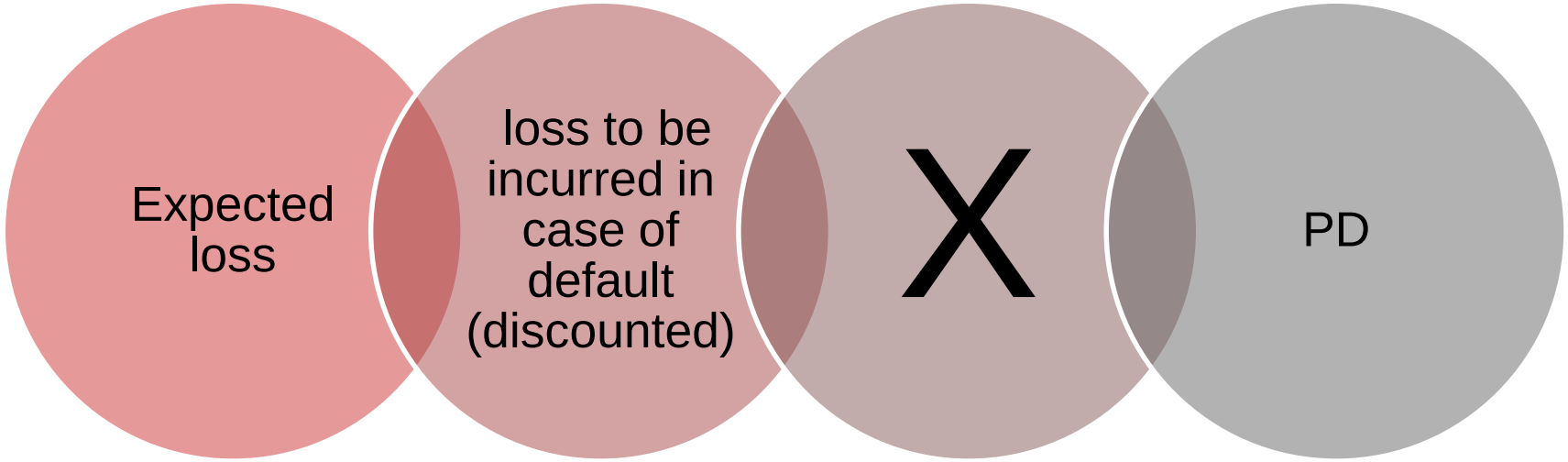
	IAS 39	IFRS 9
Impairment model	Incurred loss model • **Delays the recognition of credit losses** until there is objective evidence of impairment. • Only past events and current conditions are considered when determining the amount of impairment (i.e., the effects of future credit loss events cannot be considered, even when they are expected) • Different impairment models for different financial instruments subject to impairment testing, including equity investments classified as available-for-sale.	Expected credit loss model • Expected credit losses (ECLs) are recognized at each reporting period, even if no actual loss events have taken place. • In addition to past events and current conditions, reasonable and supportable **forward-looking** information that is available without **undue cost or effort** is considered in determining impairment. • The model will be applied to all financial instruments subject to impairment testing.

Phase II: Impairment
Stages on Impairment Assessment

	Stage 1	Stage 2	Stage 3
Criteria	No significant increase in credit risk since initial recognition / low risk	Significant increase in credit risk since initial recognition	Default (credit impaired)
Backstops		30 days past due	90 days past due
Basis for Provision	12-month expected credit losses	Lifetime expected credit losses	
Basis for Interest Income	Gross carrying amount		Amortised cost

Credit risk deterioration since initial recognition

Excepted Credit Loss (ECL)



Calculating expected credit losses-ECL

An unbiased evaluation of a range of possible outcomes and their probabilities of occurrence.

Discounting for 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.

Impairment

Incurred loss model

- Currently used by IAS 39
- Credit losses are recognised only <u>if an event has occurred</u> that has a <u>negative effect on future cash flows &</u> that effect can be reliably estimated
- An entity is not permitted to consider the effects of future expected losses

The challenge

- Financial meltdown
- Too big to fail
- Cliff effect
- Risk taking
- Complex disclosures
- Bonus culture

Expected loss model

- Proposed way forwards
- Requires an entity to make an ongoing assessment of expected credit losses
- Will require earlier recognition of credit losses in many cases

Scope exclusions

Financial assets credit impaired on initial recognition

- Includes both originated and purchased credit-impaired assets
- Outside of scope of the above model
- Consistent with IAS 39 (AG5)

Trade receivables without a significant financing component

- Practical expedient to enable entities to calculate losses using certain current practices eg, group receivables by age and applying historical loss rates (proxy matrix).
- Implied application to non-financial services entities
- Recognition of full lifetime expected loss on a matrix model basis

Low credit risk

- If the credit risk is determined to be low at the reporting date
- Impairment can be measured using 12-month ECL
- Presumption that no significant increase in credit risk has occurred

- There is a low risk of default

+

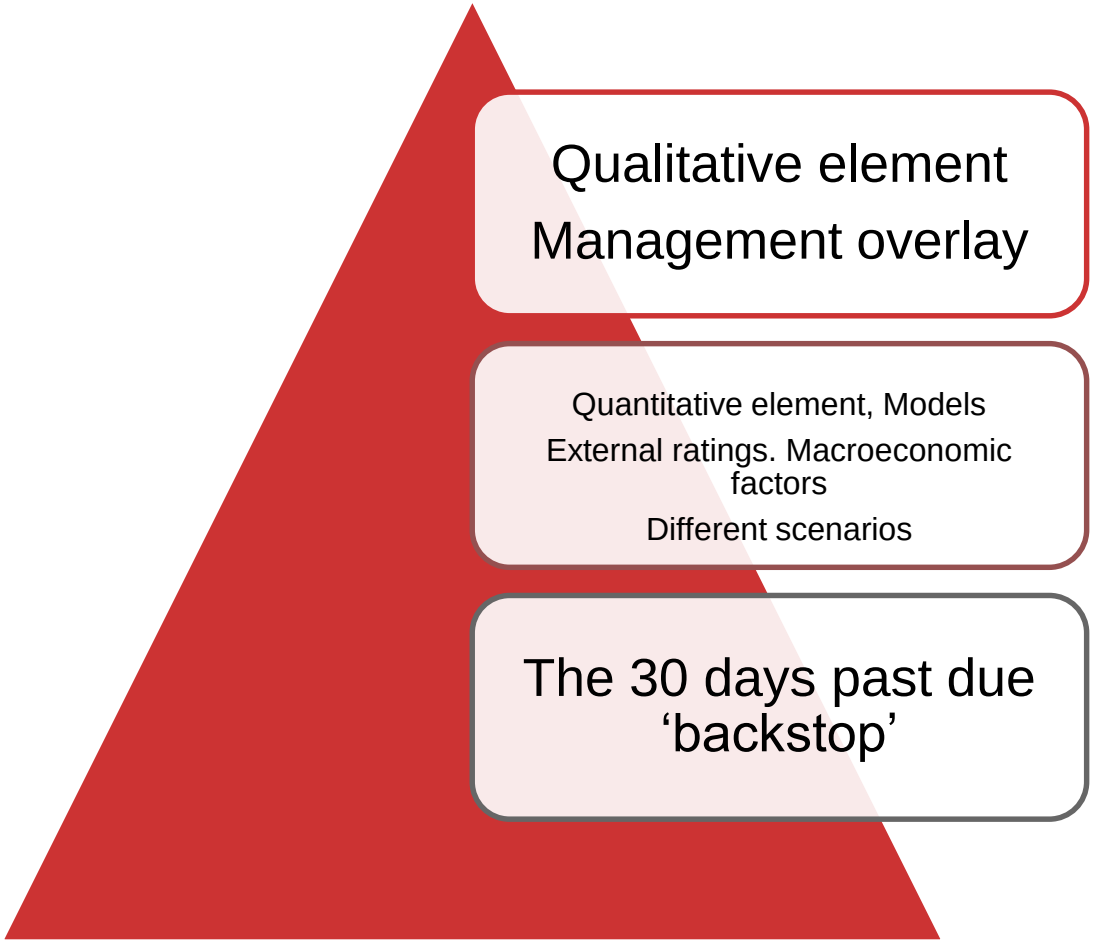
- Borrower has strong capacity to meet obligations in the short term

+

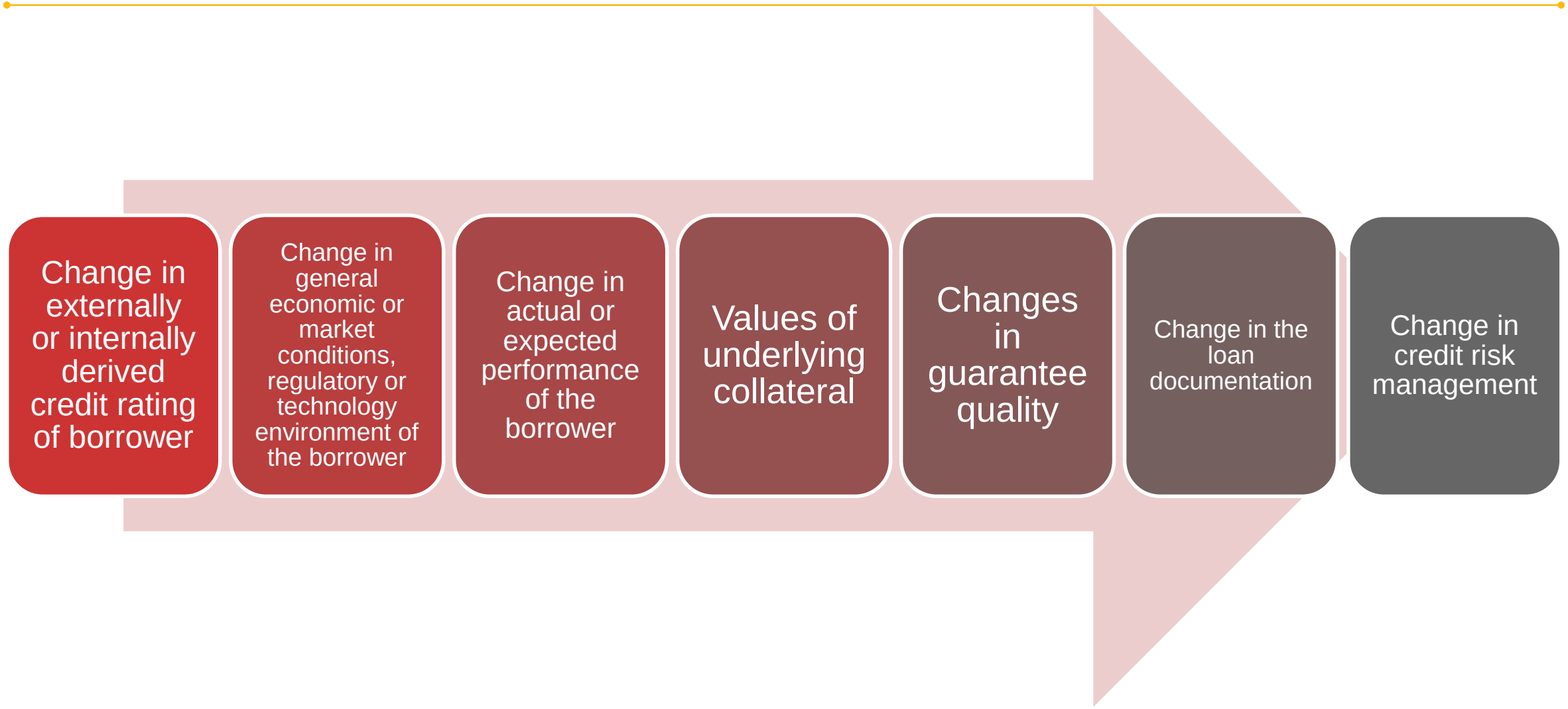
- Adverse changes in economic or business conditions in the longer term wont necessarily reduce ability to fulfil obligations

- Risk is evaluated without consideration of collateral
- Not considered low risk just through comparison to entity's other instruments or the jurisdiction in which the entity operates
- Internal ratings are permitted providing consistent with a global rating definition of 'investment grade'

Significant increase in credit risk (SICR)



Significant increase in credit risk



Challenges

Strategic	Tactical	Operational
• Impact on Capital • Impact on earnings stability and other KPIs • Managing stakeholders' and market expectations	• Define indicators and thresholds for level migration, especially between levels 1 and 2 • Define and identify key information to bridge current models to multi-year EL requirements • Align with peer group	• Data availability • Data quality • Financial reporting • Management reporting • Regulatory reporting • Impact on IT systems (model on model)

Hedging

Simplified

More items qualify for hedge accounting, e.g. hedging the benchmark pricing component of commodity contracts and net foreign exchange cash positions –

Entities can hedge account more effectively their exposures that give rise to two risk positions (e.g. interest rate risk and foreign exchange risk, or commodity risk and foreign exchange risk) that are managed by separate derivatives over different periods –

Less profit or loss volatility when using options, forwards and foreign currency swaps.

Hedging

Hedged item

Fair value
Future cash flows

Hedging instrument

Designated derivative or other financial asset or liability whose fair value or cash flows are expected to offset changes in the fair value of the designated hedged item

Most often a derivative

Gains and losses on hedged items and hedged instruments can be accounted for under hedge accounting rules provided the hedging relationship is **formally designated & documented** and **expected to be highly effective.**

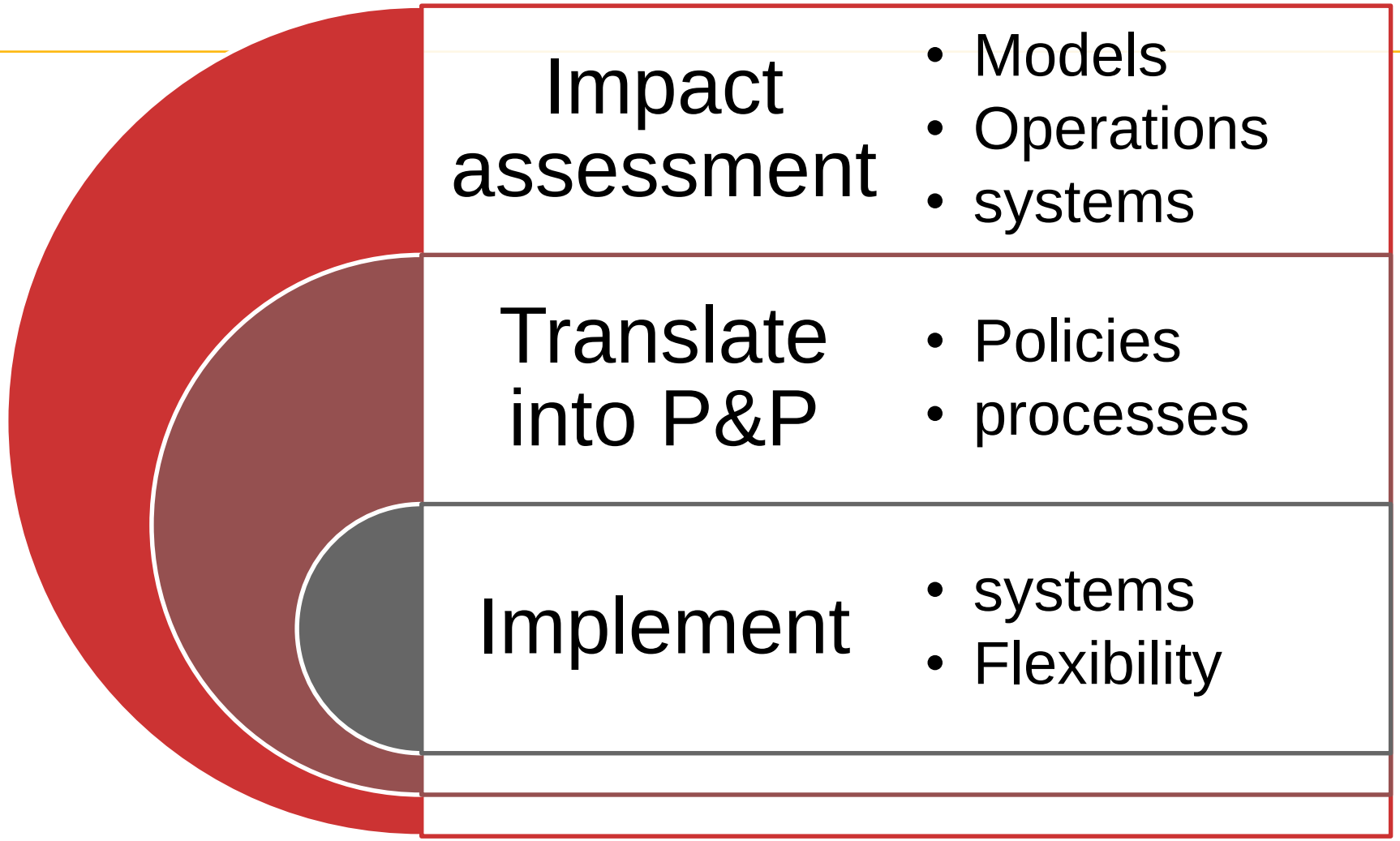
Hedging types

Fair Value Hedge → **Hedge of fair value of a recognised asset or liability or unrecognised firm commitment** → **Hedged item & hedging instrument re-measured to fair value via profit or loss**

Cash Flow Hedge → **Hedge of cash flow volatility associated with a recognised asset or liability or highly probable forecast transaction** → **Effective gain or loss on hedging instrument to equity until hedged item affects profit or loss**

Outcome is that gains & losses on hedged item and hedged instrument matched in P/L in same period

Takeaways



Takeaways

Integration:

✓Risk

✓Compliance

✓finance

Q&As

Thank You

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