ELF
الاتحاد المصرى للتأجير التمويلى
Egyptian Leasing Federation

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IFRS 9

Financial Instruments

WAG ACADEMY
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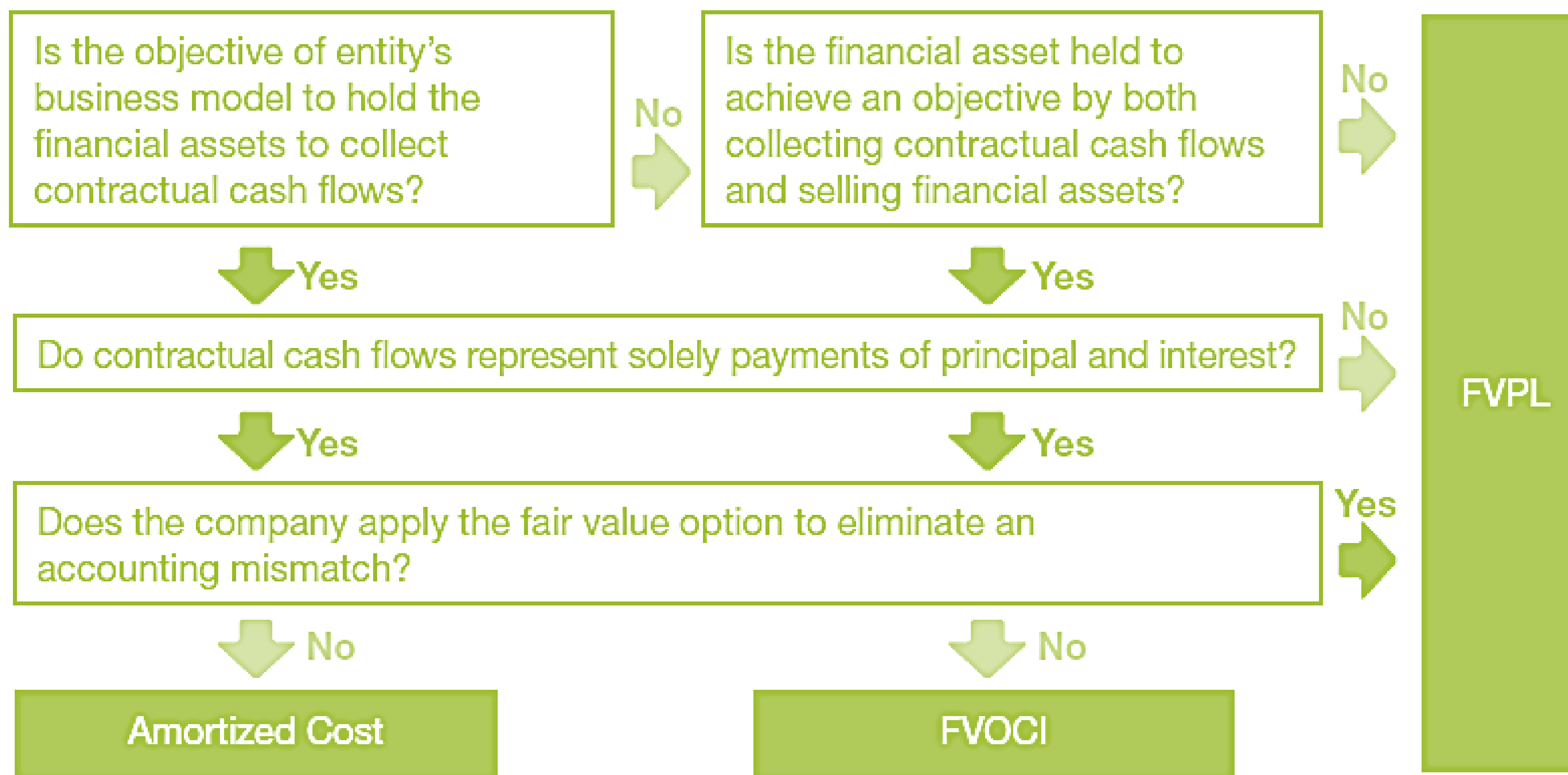
SILVER LEARNING PARTNER
ACCA

IFRS 9 vs IAS 39

IFRS 9	IAS 39	
Classifications and measurement models	Classifications	Measurement model
Amortized Cost	Loans and receivables	Amortized Cost
FVPL	FVPL	FVPL
FVOCI	Available for sale	FVOCI
	Held to maturity	Amortized Cost

Decision tree



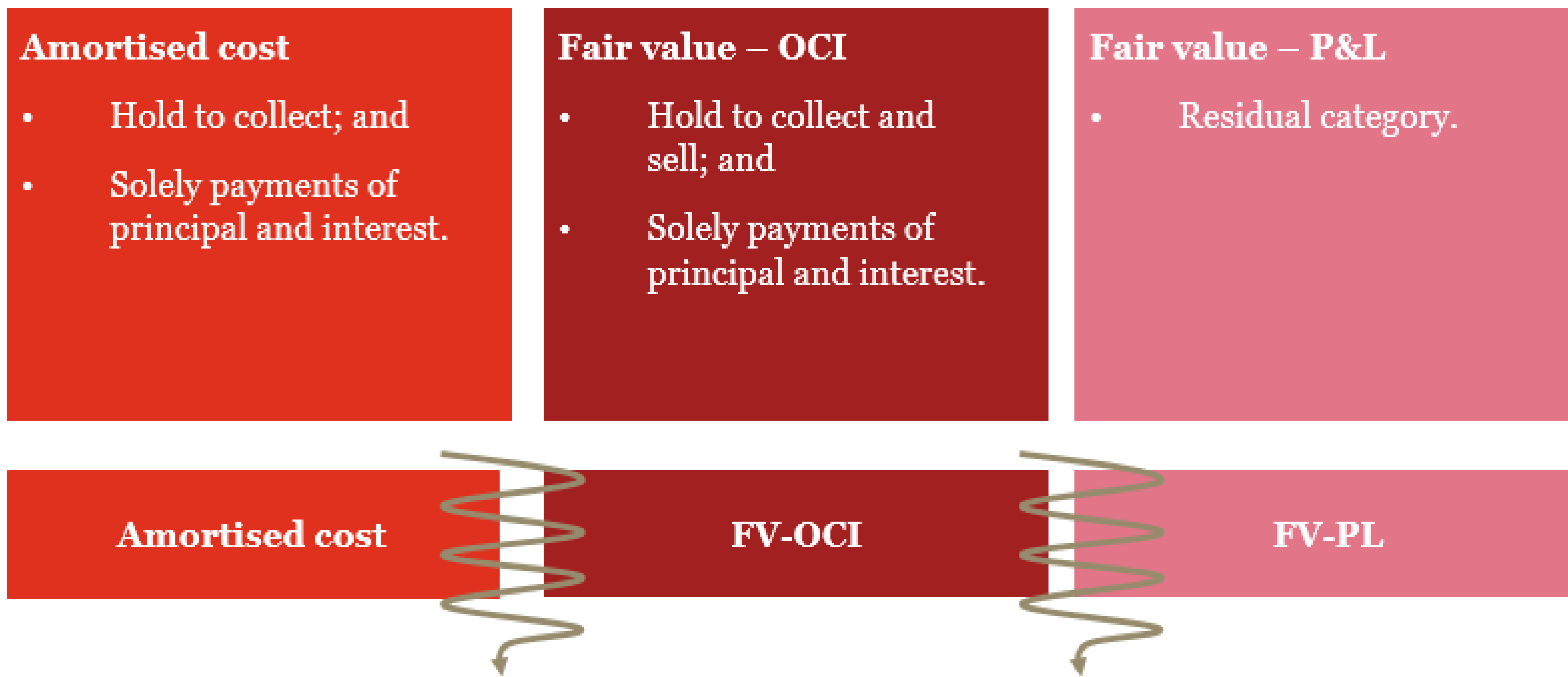
IAS 32 – Presentation of liabilities and equity

- Financial instruments (or their component parts) must be classified as liabilities or equity in accordance with their substance
  - preference shares could be classified as liabilities
- Payments to the providers of capital must be classified as interest or dividends accordingly
  - dividends on preference shares that are classified as liability will be recognised as expense

Liability or equity?

- A financial liability is:
  - any liability that is a contractual obligation:
    - to deliver cash or another financial asset to another entity; or
    - to exchange financial instruments with another entity under conditions that are potentially unfavourable
- Definition is applied based on substance
  - If the issuer has an option to redeem and in practice will be economically compelled to do so - liability

Classification and measurement of financial assets- Debt instruments



Example of categories disclosure

24. Investment securities[a]

See accounting policy on Note 45(O).

	In millions of euro	2015	2014
IFRS 7R.8(a)(ii)	Investment securities mandatorily measured at FVTPL	**1,457**	
IFRS 7R.8(a)(i), 7.8(a)(i)	Investment securities designated as at FVTPL	**3,045**	3,239
IFRS 7R.8(f)	Investment securities measured at amortised cost	**410**	
IFRS 7R.8(h)(i)	Investment securities measured at FVOCI – debt instruments	**1,363**	
IFRS 7R.8(h)(ii)	Investment securities designated as at FVOCI – equity investments	**27**	
IFRS 7.8(b)	Held-to-maturity investment securities		101
IFRS 7.8(d)	Available-for-sale investment securities		1,929
		6,302	5,269

Classification and measurement of financial assets- Equity-FVOCI

- Presentation of FV changes in OCI (like AFS under IAS 39 with some changes)
- Available for all equity instruments that are not held for trading
- Free choice for each holding of an instrument at initial recognition Irrevocable for that holding (no reclassification)
- Dividends will be recognized in profit or loss.
- No recycling of fair value changes to profit or loss on impairment, disposal or in any other circumstances.

- No impairment testing required
- Additional disclosures

Classification and measurement of financial assets- Debt-FVOCI

- Interest income should be recognized in profit or loss using the effective interest method that is applied to financial assets measured at amortised cost
- Credit impairment losses/reversals will be recognized in profit or loss using the same credit impairment methodology as for assets measured at amortised cost
- Net cumulative fair value gain or loss recognized in OCI should be recycled from OCI to profit or loss when these financial assets are derecognised
- Changes in fair value for reasons other than credit (e.g., a liquidity discount) will not be recorded in profit or loss until derecognition

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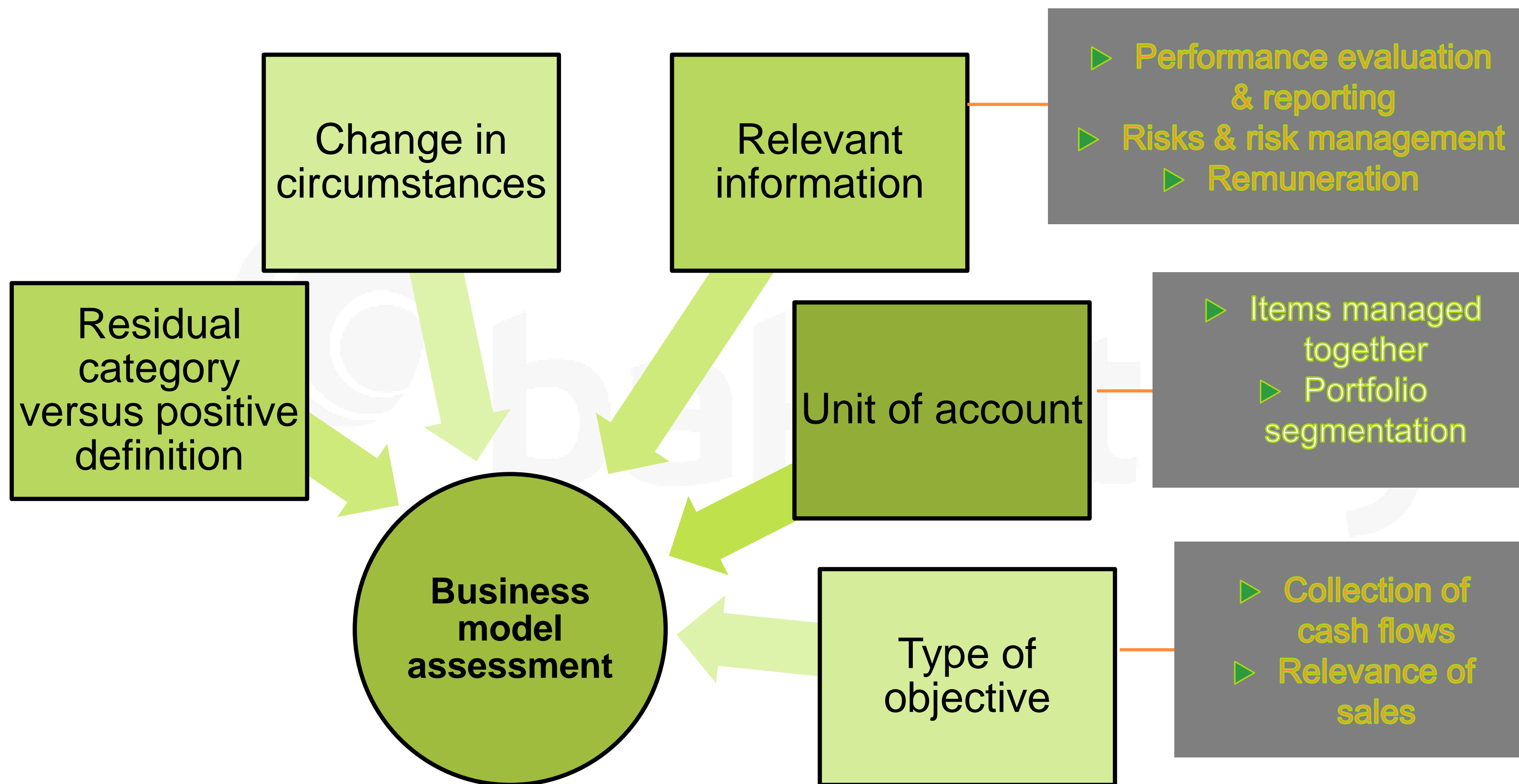
Initial Measurement

- At initial recognition, all financial assets are measured at fair value.
- Fair value should include transaction costs included in all assets other than those categorised at fair value through proift or loss.

Accounting for assets reclassification

From	To	Requirement
Amortized Cost	FVPL	Measure fair value at reclassification date and recognize difference between fair value and Amortized Cost in profit and loss
FVPL	Amortized Cost	Fair value at the reclassification date becomes the new gross carrying amount
Amortized Cost	FVOCI	Measure fair value at reclassification date and recognize any difference in OCI
FVOCI	Amortized Cost	Cumulative gain or loss previously recognized in OCI is removed from equity and applied against the fair value of the financial asset at the reclassification date
FVPL	FVOCI	Asset continues to be measured at fair value but subsequent gains and losses are recognized in OCI rather than profit and loss
FVOCI	FVPL	Asset continues to be recognized at fair value and the cumulative gain or loss previously recognized in other comprehensive income is reclassified from equity to profit and loss

How to assess the business model



Business Model Assessment

Based on the overall business, not instrument-by-instrument.

- Focus on whether financial assets are held to collect contractual cash flows:
- How the entity is run
- The objective of the business model as determined by key management.

The business model is:

- classification to be determined at the portfolio level
- It is a matter of fact and not management intent
- Financial assets do not have to be held to contractual maturity in order to be deemed to be held to collect contractual cash flows, but the overall approach must be consistent with 'hold to collect'.

Business Model Assessment (Cont.)

Examples of sales that will not violate hold to collect business model:

- Sales due to deterioration in credit quality in line with a documented investment policy
- Infrequent sales (e.g., unanticipated stress scenarios), even if significant
- Insignificant sales, both individually and in aggregate, even if frequent
- Sales made close to the maturity and the proceeds approximate the collection of the remaining cash flows

‘Business model’ test

- The objective of the entity’s business model is to hold instruments to collect contractual cash flows rather than to sell instruments prior to contractual maturity to realise fair value changes:
  - Not an instrument-by-instrument approach
  - Classification to be determined at the portfolio level
  - It is a matter of fact and not management intent

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Contractual Cash Flows (SPPI)

- Interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time

IFRS 9 defines principal as the fair value of a financial asset at initial recognition, which may change over the life of a financial instrument (for example, if there are repayments of principal). Interest is the consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks (e.g., liquidity risks) and costs (e.g., administrative costs), as well as a profit margin.

Liabilities

- Liabilities are valued at amortised cost unless they are held for trading, in which case they are FVTPL.

- IFRS 9 permits entities to opt to designate liabilities which would normally fall to be measured at amortised cost, to be designated at fair value through profit or loss (Fair value Option (FVO)).

- This designation, if made, must be made upon initial recognition and is irrevocable.

Entity’s own risk (OCI vs P&L)

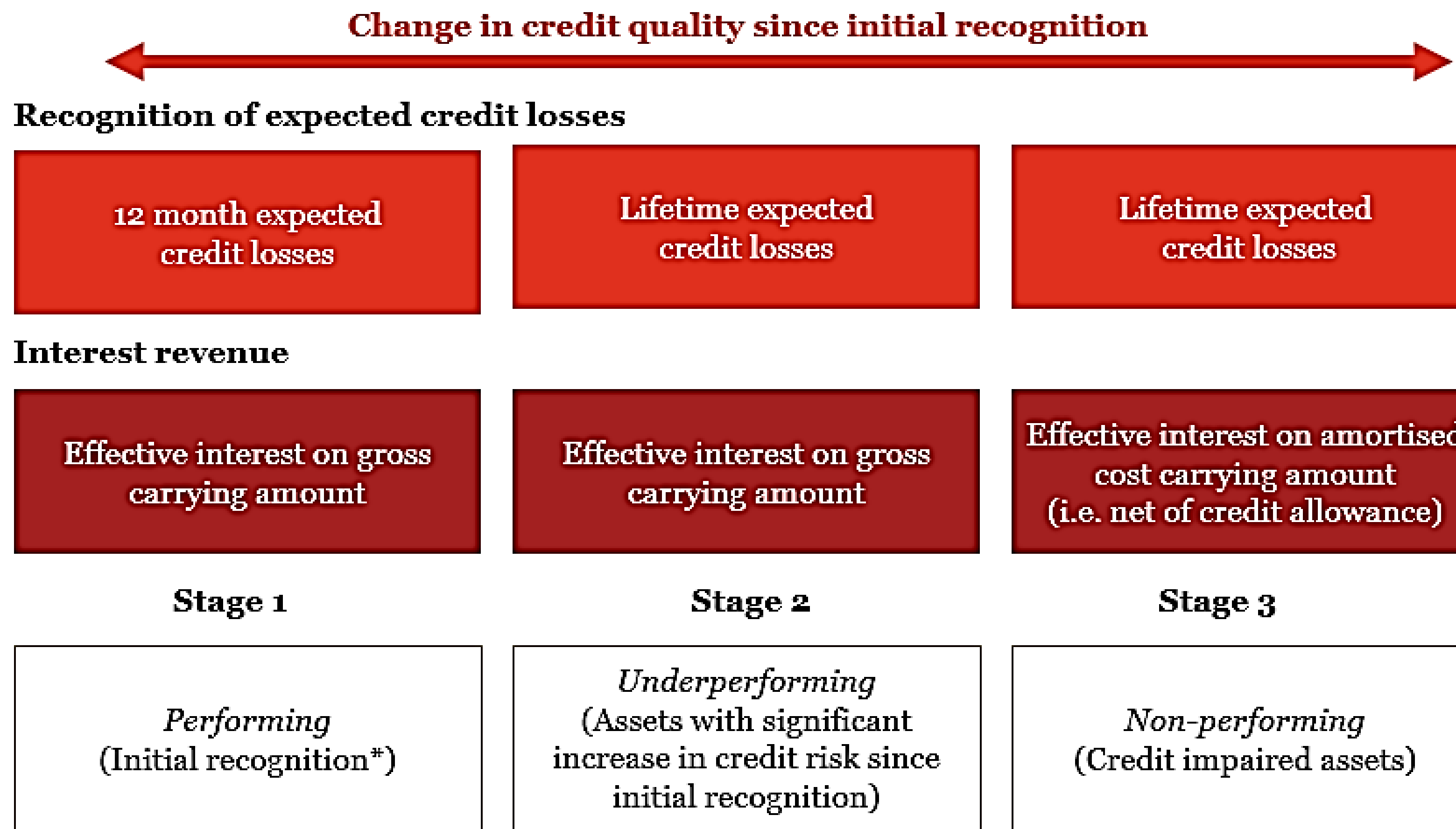
- The fair value of an entity’s own debt is affected by changes in the entity’s own credit risk (own credit).
- As an example the credit rating went down from AAA to AA.
- As a result the value of the debt instrument from investors point of view declined, that when an entity’s credit quality declines the value of its liabilities fall, and if those liabilities are measured at fair value a gain is recognized !!! in profit or loss (and vice versa).
- To address the so-called own credit issue, IFRS 9 requires changes in the fair value of an entity’s own credit risk to be recognized in other comprehensive income rather than in profit or loss.

Objective of the IFRS 9 impairment model

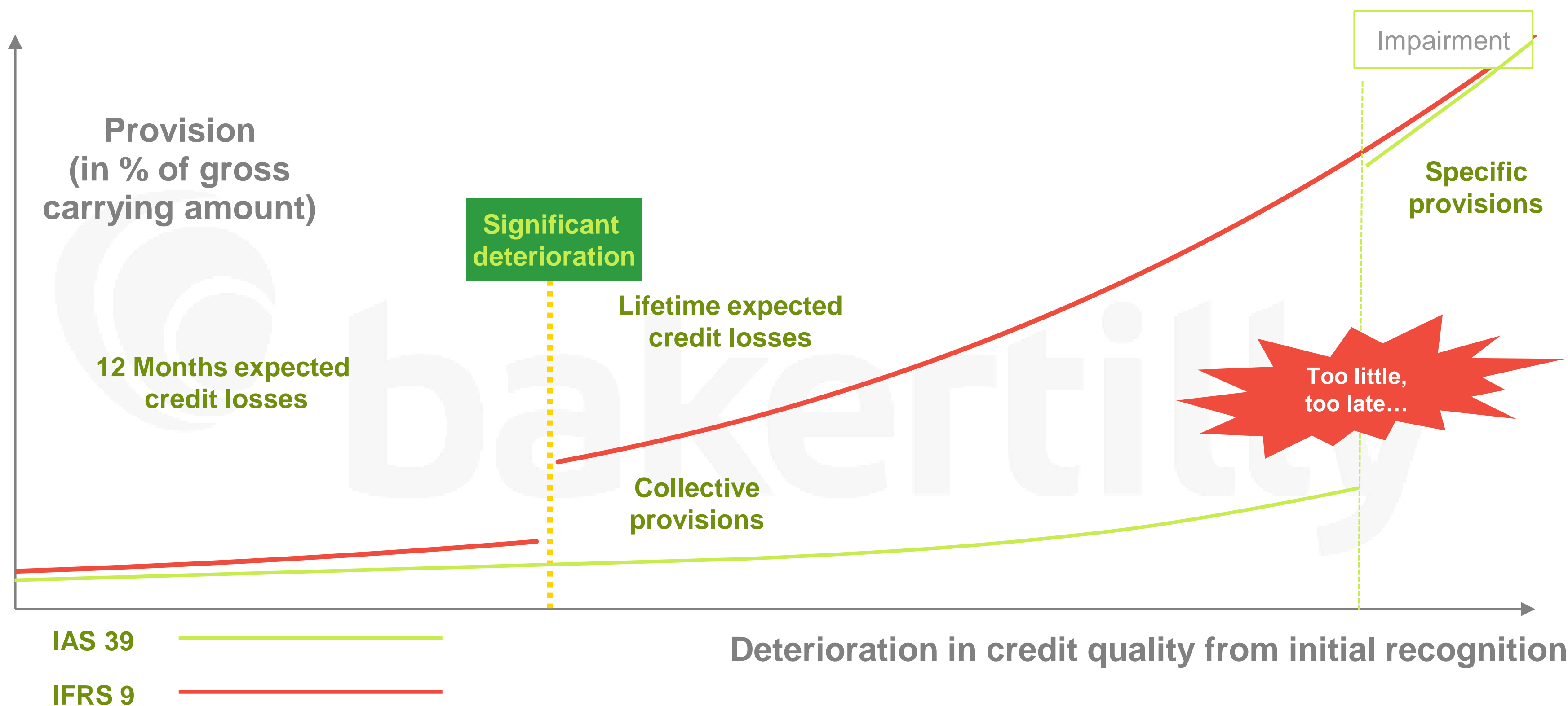
- The objective of the IFRS 9 impairment model is to recognize expected credit losses for all financial instruments within the scope of the requirements. Expected credit losses are defined as the expected shortfall in contractual cash flows. An entity should estimate expected credit losses considering past events, current conditions and reasonable and supportable forecasts.
- The IASB believes that this will provide users of financial statements with more useful and timely information.

IFRS 9 Expected credit loss model

- General model:



ECL VS incurred

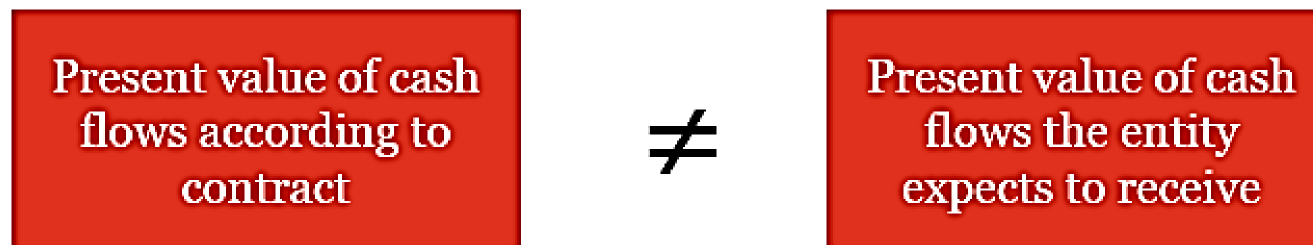


ECL

Expected credit losses

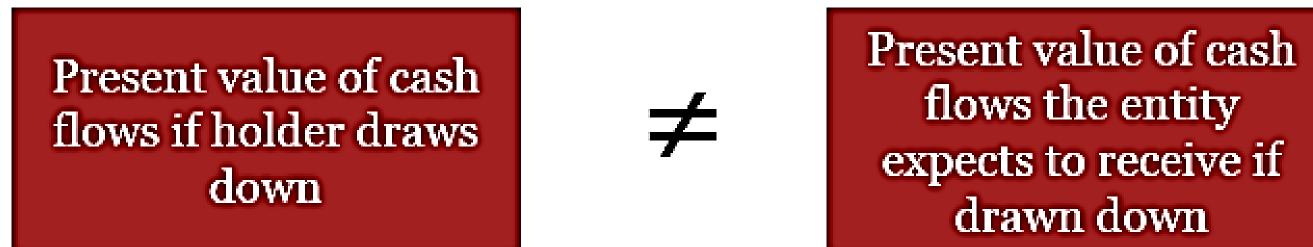
Financial assets

ECL represent a probability-weighted estimate of the difference over the remaining life of the financial instrument, between:



Undrawn loan commitments

ECL represent a probability-weighted estimate of the difference over the remaining life of the financial instrument, between:



Inputs into ECL

Inputs, assumptions and techniques used for estimating impairment (continued)

Measurement of ECL

The key inputs into the measurement of ECL are the term structure of the following variables:

- probability of default (PD);
- loss given default (LGD);
- exposure at default (EAD).

Illustrative example: PD approach

12-month ECL allowance	PD x LGD x EAD
	0.15% x 25% x $1 m = $375 ► Loan originated at $1 million, i.e., exposure at default (EAD) ► 25% gross carrying amount irrecoverable if loan defaults, i.e., loss given default (LGD) ► 0.15% probability of a default (PD) in next 12 months
Challenges	► Correlating PD and LGD ► Relying on rating agencies' data ► Individual vs collective assessment

Illustrative example: provision matrix

Lifetime ECL allowance

Days past due (DPD)	0–30	31–90	Over 90
Carrying amount	$800,000	$200,000	$50,000
Lifetime ECL rate	1%	5%	10%
Lifetime ECL	$8,000	$10,000	5,000

- Portfolio of trade receivables categorised by common risk characteristics

Challenges

- Adjusting historical loss rates with forward-looking estimates

Measurement of ECLs

IFRS 9 also defines expected credit losses as “the weighted average of credit losses with the respective risks of a default occurring as the weights”.

IFRS 9 does not prescribe a particular method of measuring expected credit losses.

The Standard instead acknowledges that measurement might vary based on the type of instrument in concern and the information that is available.

It does however require that any method that an entity uses to measure credit losses should take into account the following:

- The period over which to estimate ECLs
- Probability-weighted outcomes
- Time value of money
- Reasonable and supportable information

Example

Orange Co advanced a three-year interest bearing loan of $2m to Lemon Co on 1 July 20X4. At that date management estimates the risk of default in the next 12 months as 2% and the risk of default over the remaining term of the loan as 5.5%. The loss that would result from the default was estimated at $800,000.

What is the amount of the credit loss provision that Orange Co should record on initial recognition?

Solution

The credit loss provision on initial recognition is based on the 12-month expected losses. A provision of $16,000 (2% × $800,000) should be recognised.

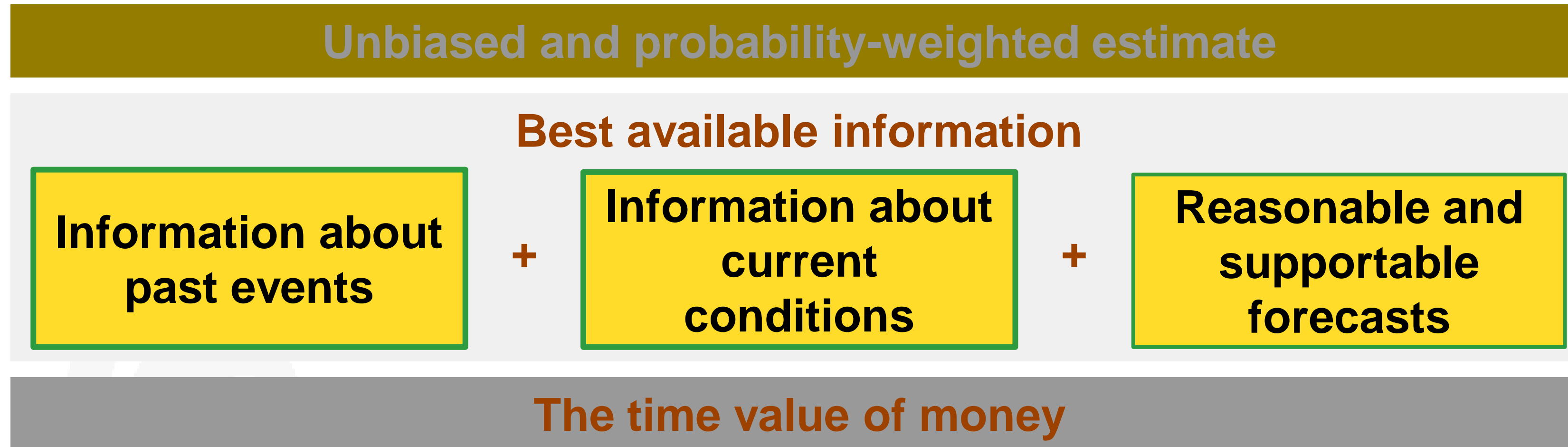
Example continued

- Orange Co has a reporting date of 31 December. By 31 December 20X4 management estimates that the risk of default in the next 12 months is 3.5% and in the remaining term of the loan is 10.5%. The loss that would result from the default was estimated at $750,000.
- What is the amount of the credit loss provision that should be included in the statements of financial position as at 31 December 20X4?
- Solution
- Since the total risk of default has increased from 7.5% on initial recognition to 14% by 31/12/X4, this would seem to be a significant increase in credit risk. The credit loss provision must therefore be based on lifetime expected losses and would be $105,000 ((3.5% + 10.5%) * $750,000).

Example continued

- By 31 December 20X5 management estimates that the risk of default in the next 12 months is 1.5% and in the remaining term of the loan is 1%. The loss that would result from the default was estimated at $450,000.
- What is the amount of the credit loss provision that should be included in the statements of financial position as at 31 December 20X5?
- Solution
- Since the total risk of default has decreased from 14% on initial recognition to 2.5% by 31/12/X5, this would seem to be a significant improvement in credit quality. The 12-month expected credit loss basis is now reinstated, and a credit loss provision of $6,750 (1.5% * $450,000) should be included.

Measuring ECL



ECL must be discounted at the *effective interest rate (EIR)* *or an approximation* thereof.

ECL should reflect *management's expectations* of credit losses and management should consider *observable market information* about credit risk.

- The measurement of ECL should incorporate the *best available information*
- *Regulatory* ECL models may form a basis for ECL calculations, but the measurement may need to be adjusted

ECL and rebuttable presumption

- Expected credit losses
- An entity's estimate of expected credit losses must reflect:
- the best available information.
- an unbiased and probability-weighted estimate of cash flows associated with a range of possible outcomes (including at least the possibility that a credit loss occurs and the possibility that no credit loss occurs).
- the time value of money.
- Various approaches can be used.
- An entity should apply a default definition that is consistent with internal credit risk management purposes and take into account qualitative indicators of default when appropriate.