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CHARTERED ACCOUNTANTS

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25 YEARS OF
PROFESSIONAL
EXCELLENCE

IFRS 9

Application Guidance

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2. SCOPE OF IFRS 9

✓Why new standard replacing IAS 39?

- IAS 39 is too complex, inconsistent with the way entities manage their risks
- defers the recognition of credit losses on loans and receivables until too late
- 2008 financial crisis made this a priority.

✓Banks and FI (Financial Assets, Instruments & Liabilities)

- Loans, Overdraft & other products with credit risk
- Equity and Embedded Securities
- Derivatives
- Impairment – General Approach

✓Corporate Sector

- All of the above
- Trade Receivables
- Due from related parties
- Impairment – Simplified Approach (subject to some criterion)

3. OUT OF SCOPE OF IFRS 9

IFRS 9 does not apply to

1.Subsidiaries & Associates

2.Leases (except for lease receivables and payables and embedded derivatives)

3.Employee benefits payable

4.Insurance Contracts

5. Mergers

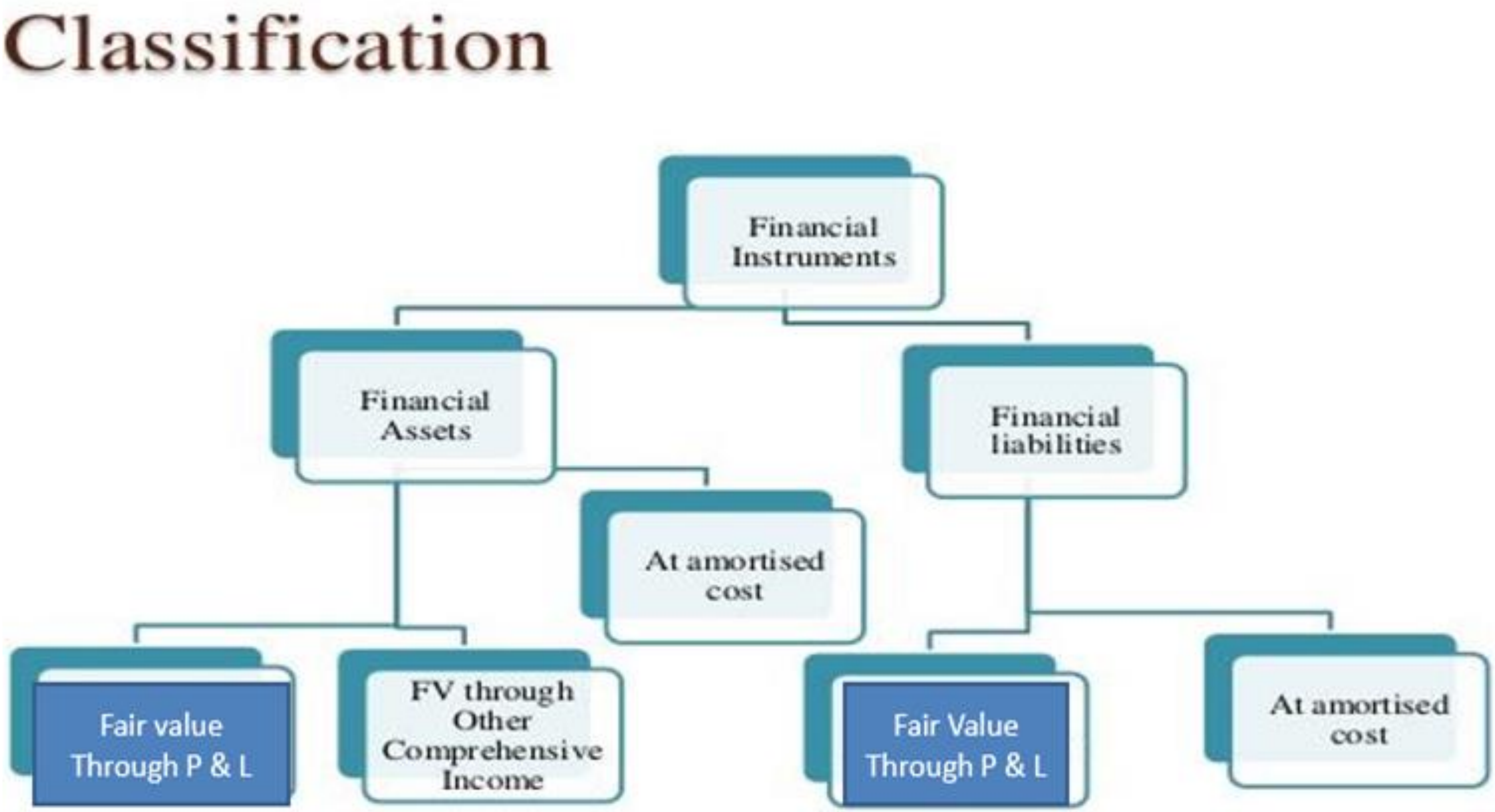
4. WHEN A FINANCIAL ASSET/ INSTRUMENT IS RECOGNIZED

A financial asset or a financial liability is recognized

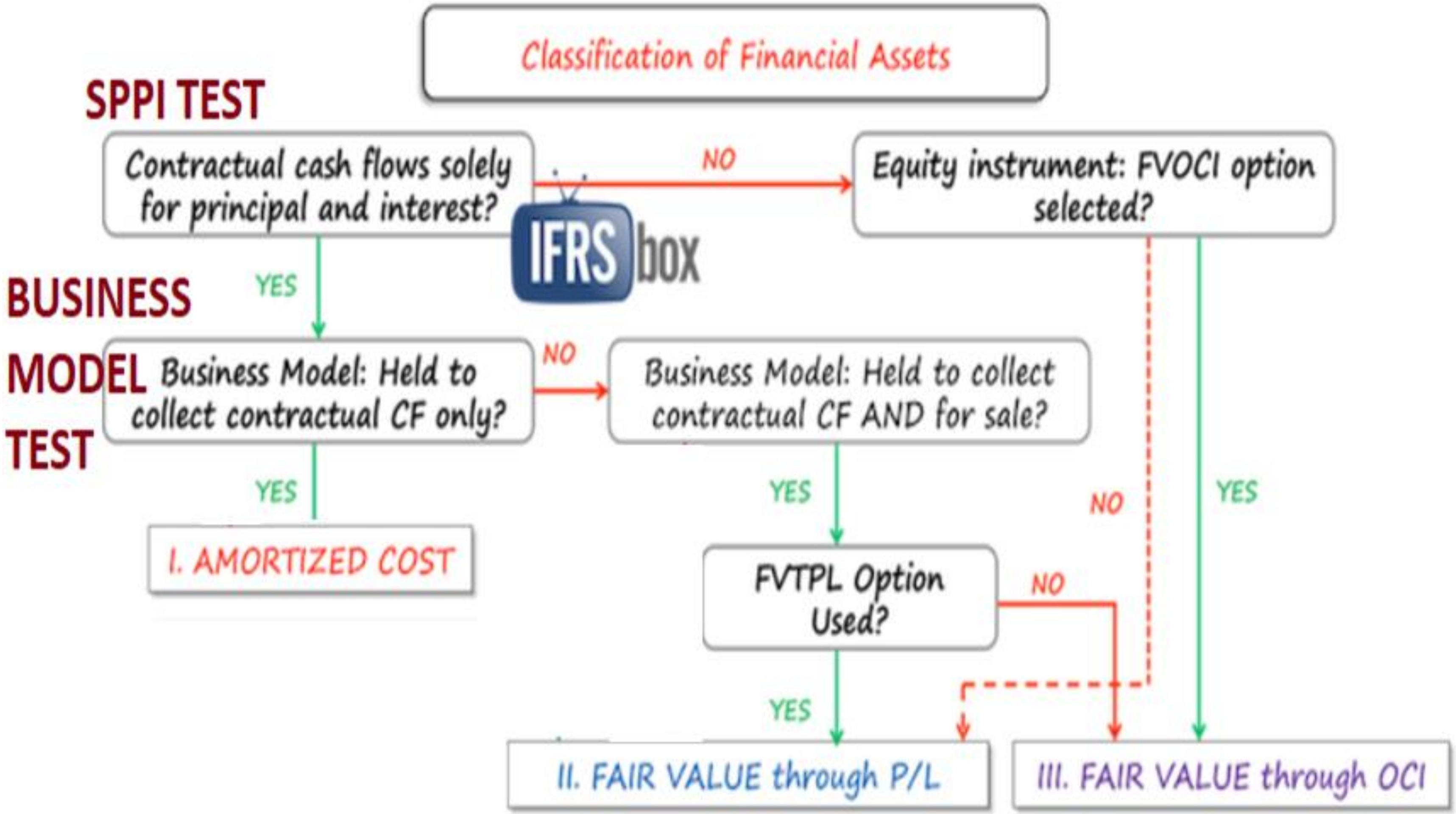
- when the entity becomes a party to the contract
- purchase of financial assets which are recognized on trade date

5. CLASSIFICATION OF FIN ASSETS & LIABILITIES

Financial asset or a financial liability has to accounted and presented in the Financial Statements. The ways in which it can be done is dependent upon certain classifications



6. CLASSIFICATION : APPLICATION IN BANKS/FI



7. SPPI TEST

SPPI – stands for Solely Payments of Principal and Interest

Entity S lends €10 million to Entity T. The terms of the loan require Entity T to repay €10 million in 3 years. The interest rate on the loan is based on EURIBOR plus 2% on €10 million payable in arrears at the anniversary date of the lending. The rate of EURIBOR is determined in advance, i.e. at the start of each annual period. There are no other features in the contractual terms that result in any variability in the contractual cash flows.

A) Fails SPPI test
B) Meets SPPI test

8. BUSINESS MODEL TEST

The assessment of a **business model** is based on how key personnel actually manage the **business**, rather than management's theoretical intent for specific financial assets.

Bank XYZ lends €10 million to Entity T. The terms of the loan require Entity T to repay €10 million in 3 years. The management decides to sell the asset in the secondary market, to get rid of the risk and improve the liquidity of the Bank. The interest rate on the loan is based on EURIBOR plus 2% on €10 million payable in arrears at the anniversary date of the lending.

A) Held to collect Contractual CF only?
A) Held to collect both Contractual CF & sale?

9. Financial Assets at FVTPL

1. Financial assets that do not meet the amortised cost criteria
2. Financial assets of nature of equity & derivatives

Critical judgment criteria: whether the business model is for sale in the short term

For example: Investing in Shares/bonds held for trading.
Positions in derivatives – calls and puts

10. FINANCIAL ASSETS AT FVOCI

1. Available only for investments (AFS) in equity instruments that are not held for trading.
2. For debt instruments, they meet the SPPI contractual cash flow characteristics test and entity holds the instrument to collect contractual cash flows and to sell the financial assets.

Example

- investments in shares and bonds with a long term dimension (Please note that this can be sold to realize the cash at a future date. Sometimes bonds are also possible to be classified under this)

11. FINANCIAL LIABILITIES

1. Financial Liabilities at Fair Value Through Profit or Loss

- ❑ Financial liabilities held for trading
- ❑ Derivative financial liabilities
- ❑ Financial liabilities designated at initial recognition as at Fair Value.

Examples

- -A company issues a bond i.e. borrows and the bond is trading on a stock market with intention to buy back.
- -Derivatives , that results in a liability or obligation.

2. Financial Liabilities at Amortized Cost : All other financial liabilities. These include trade payables and loans.

12. IMPAIRMENT

USUAL FINANCIAL ASSETS/INSTRUMENTS COVERED

- Financial assets at amortised cost
- Financial assets (debt instruments) at FVOCI
- Loan commitments
- Financial guarantee contracts
- Lease receivables and trade receivables or contract assets

13. IMPAIRMENT – FOR BANKS/ FI

General model

Change in credit quality since initial recognition

Recognition of expected credit losses

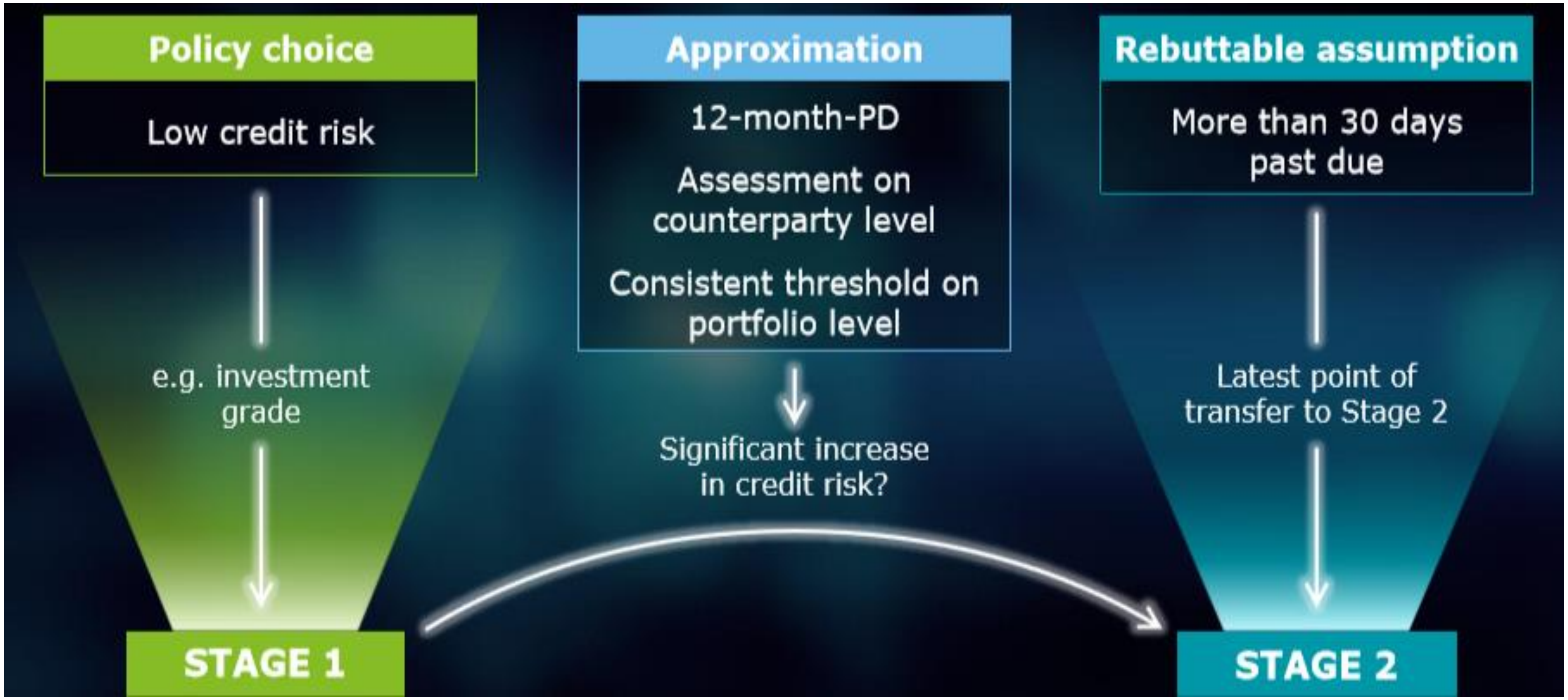
12 month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses

Interest revenue

Effective interest on gross carrying amount	Effective interest on gross carrying amount	Effective interest on amortised cost carrying amount (i.e. net of credit allowance)

Stage 1	**Stage 2**	**Stage 3**
Performing (Initial recognition*)	*Underperforming* (Assets with significant increase in credit risk since initial recognition*)	*Non-performing* (Credit impaired assets)

14. IMPAIRMENT – FOR CORPORATES



15. Corporate Balance Sheet

IFRS 9 impacts the impairment in a corporate balance sheet as follows:

Corporate balance sheet – Assets (illustrative)

Balance sheet line item	ECL impact
ASSETS	
Bank balances	
Trade and other receivables	
Investments - Equity	
Investments - Bonds	
Inventory	
Property, plant and equipment	

Trade & other receivable	Impairment
Trade receivable	
Contract assets	
Related party dues	
Advance to suppliers	
Refundable security deposit	
Pre-paid expenses	

Impact	
High	
Low	
No impact	

- Simplified approach
- Low credit risk exemption

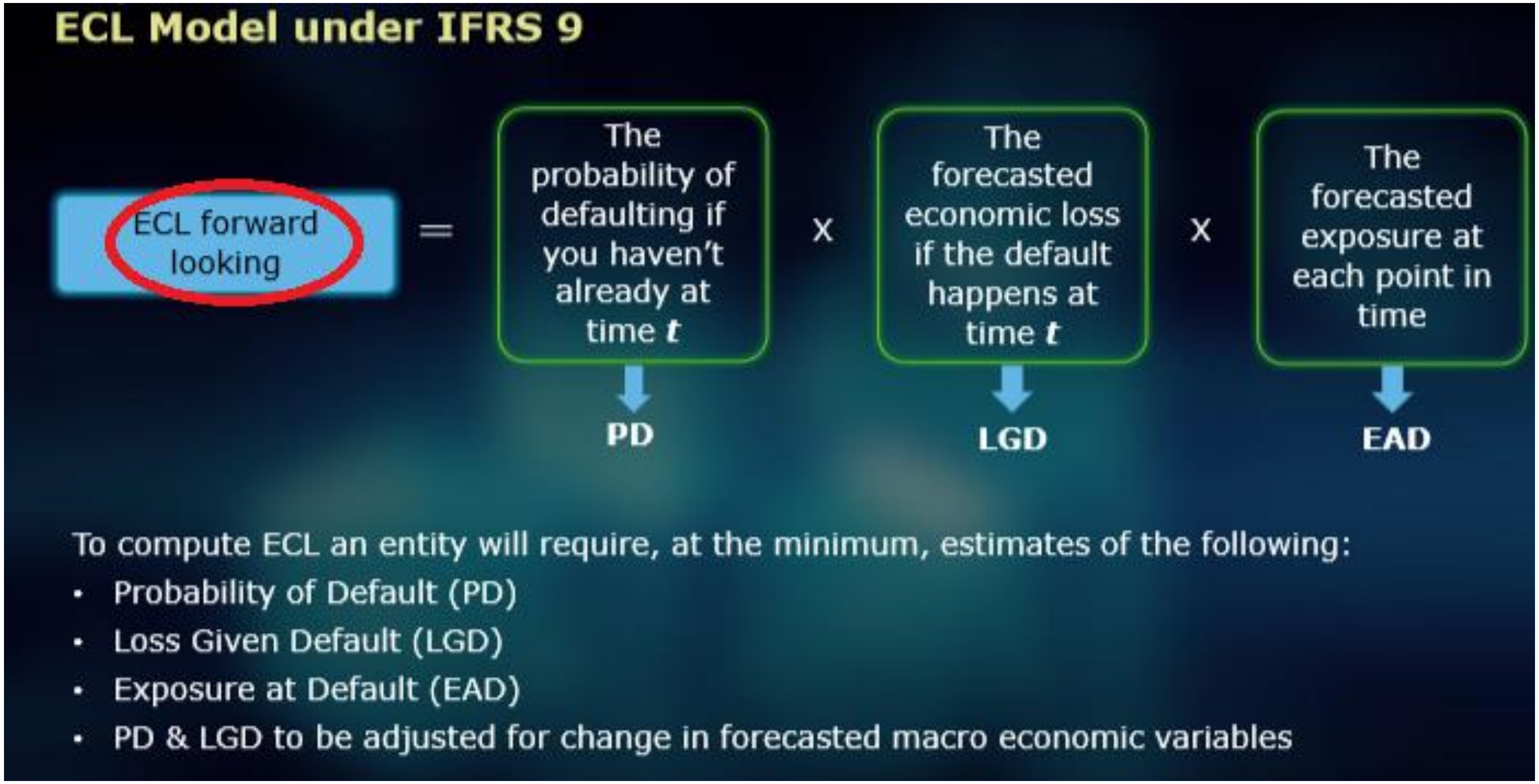
16. TRADE RECEIVABLES - Impairment

- Pre – IFRS 9 : Incurred Loss Model. An incurred loss model assumes that all loans will be repaid until evidence to the contrary (known as a loss or trigger event) is identified. Only at that point is the impaired loan (or portfolio of loans) written down to a lower value.

- IFRS 9 : Expected Loss Model. Under this model, impairment does not wait for a 'Credit Event' to trigger. Based on the history, current market conditions and macro economic environment, the Probability of Default of each Customer (or) Category of Customers is calculated and provided for.

- While Incurred Loss Model was reactive, Expected Loss Model is proactive.

17. Expected Credit Loss Calculation - Impairment



18. A/R – Impairment Steps

When applying the ‘simplified approach’ to, for example, trade receivables with no significant financing component, a provision matrix can be applied.

Following are the steps to arrive at a provision matrix.

- Step 1 : Determine the **appropriate groupings of receivables** into categories of shared credit risk characteristics.
- Step 2 : Develop ‘Probability of Default’ from the above data
- Step 3 Determine the historical loss rates to arrive a LGD.
- Step 4 Consider forward looking macro-economic factors and adjust historical loss rates to reflect relevant future economic conditions.
- Step 5 Calculate the expected credit losses.

- ❑ In case of collateral and it has value, such collateral value shall be netted off while arriving at the expected credit loss
- ❑ In case there is bank guarantee etc, the PD of the bank shall be substituted for the obligor / debtor PD
- ❑ Ideally historical data of 3-5 years to be mined and studied

19. Example – Customer wise

*Default is defined by management as 180 days based on internal credit related measuring policies

Customer name	Issued amount (QAR'000)	Received amount (QAR'000)	Default	Days past due	Default days	Default amount (QAR'000)	Amount recovered (QAR'000)
A	100,000	100,000	No	1	0	-	-
B	100,000	50,000	Yes	1334	1154	100,000	50,000
C	100,000	100,000	No	90	0	-	-
D	100,000	0	Yes	760	580	100,000	-
E	100,000	100,000	No	-15	0	-	-
F	100,000	50,000	Yes	1028	848	50,000	-
G	100,000	100,000	No	89	0	-	-
H	100,000	100,000	No	25	0	-	-
I	100,000	20,000	Yes	744	564	100,000	20,000
J	100,000	0	Yes	586	406	100,000	-
	1,000,000	620000				450,000	70,000

Probability of default (A)	45%	450K/1000K
LGD (B)	84%	1-(70K/450k)

20. Example – ECL/ Provision Matrix

One method is to develop a ECL Matrix by debtors aging

Entity creates a provision matrix that is based on its historical observed default rates over the expected life of trade receivables and adjusts it for forward looking estimates.

Age	Default rate	Gross carrying amount	ECL allowance
	A	B	A x B
Current	0.3%	CU15,000,000	CU45,000
1-30 days PD	1.6%	CU7,500,000	CU120,000
31-60 days PD	3.6%	CU4,000,000	CU144,000
61-90 days PD	6.6%	CU2,500,000	CU165,000
>90 days PD	10.6%	CU1,000,000	CU106,000
		CU30,000,000	CU580,000

Q: Customers with 7.5% default rate is covered by a XYZ Bank, rated AA by an external rating agency and has a PD of 0.3%. Will you adjust the (Expected) Credit Loss Allowance?

Q: What about related party loans and inter-co dues?

21. Example – ECL/Provision Matrix

Another method is rate the customers, based on the historical study, develop a Matrix

Company X has trade receivables of CU100 million at 31 December 20X8. In order to determine the expected credit losses for the portfolio, Company X uses a provision matrix based on a credit rating score. Each customer is assigned a credit rating score based on their geographical location (e.g. postcode), industry and payment behaviour. The provision matrix is based on its historical observed default rates, adjusted for forward looking estimates. Company X estimates the following provision matrix at 31 December 20X8:

Rating score		Expected default rate (A)	Gross carrying amount (B)	Credit loss allowance (A x B)
80-100	very good payment history	0.5%	CU49,000,000	CU245,000
60-79	good payment history	1.5%	CU20,000,000	CU300,000
40-59	average - needed follow ups	3.5%	CU15,000,000	CU525,000
20-39	below average - high cr risk	7.5%	CU4,000,000	CU1,050,000
0-19	default - troubled debtors	15.0%	CU2,000,000	CU300,000
Totals			**CU100,000,000**	**CU2,420,000**

Company X provides for CU2,420,000 in its credit loss allowance account. The CU2,420,000 also include the provision for trade receivables that are current (i.e. not yet overdue).

Q: Customers with 7.5% default rate is covered by a XYZ Bank, rated AA by an external rating agency and has a PD of 0.3%. Will you adjust the (Expected) Credit Loss Allowance?

Q: What about related party loans and inter-co dues?

22. External events and ECL

Forecast of future economic conditions

The ITG discussed the challenges of whether and how to incorporate new information and events that occur after the reporting date but before the signing date of financial statements.

Scenario

- Entity A has a December year end;
- Entity A's trade receivables consists of customers that are iron ore miners;
- At 31 December 20X6, the spot iron ore price is CU80/tonne. The consensus forecast price for iron ore is also CU80/tonne;
- On 31 January 20X7 the iron ore price collapses to CU30/tonne. The collapse of the iron ore price is a result of oversupply and too little demand from steel mills.

Question: Should Entity A, for its 31 December 20X6 financial statements factor in the effect of the iron ore price collapse in to the calculation of ECL and assessment of significant increase in credit risk?

Q&A