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Financial Instruments: Update of IPSAS 28-30

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Session Outline

- Overview IPSASs- Financial Instruments
- Key Changes Introduced by IFRS 9
  - Classification and Measurement
  - Impairment: Expected Loss Model
- What’s Next

Overview of Current IPSASs on Financial Instruments

	IPSAS	IFRS	Convergence
Financial Instruments: ***Presentation***	**IPSAS 28**	**IAS 32** **Updates** (Including amendments up to December 2008)	**Primarily converged** Additional application guidance on contractual arrangements and non-exchange transactions
Financial Instruments: ***Recognition and Measurement***	**IPSAS 29**	~~**IAS 39**~~ **IFRS 9** (Including amendments up to April 2009)	**Primarily converged** Additional guidance on concessionary loans and financial guarantees
Financial Instruments: ***Disclosures***	**IPSAS 30**	IFRS 7 **Updates** (Including amendments up to April 2009)	**Primarily converged** Additional requirements for concessionary loans

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Overview of IFRS 9: Financial Instruments

Phase I Classification & Measurement	Phase II Impairment	Phase III Hedge Accounting
• Financial assets – significant changes • Financial liabilities – own credit risk	• Expected loss model – dual measurement approach	• Principles-based approach to align with risk management • Flexibility in hedging instruments & hedged items

Effective January 1, 2018, early adoption permitted.

IFRS 9: *Financial Instruments*

Phase I: Classification & Measurement

IFRS 9: Classification & Measurement – Key Changes

- New classification model for financial assets
  - ➢ Business model
  - ➢ Contractual cash flow characteristics

Overall: Conceptual approach, principles – based, and reflects asset management

- Classification of financial liabilities
  - ➢ IAS 39 with minor changes
  - ➢ Gains/losses from changes in own credit risk - OCI

Overall: Key change is to addresses the “own credit” issue

IFRS 9: Classification & Measurement – Financial Assets

IPSAS 29 (IAS 39)	IFRS 9
Fair Value Through Surplus & Deficit (FVTSD) • Held for trading • FV option election	Fair Value Through Profit and Loss (FVTPL) • Held for trading • FVTPL designation
Available for Sale (AFS)	FVOCI (Debt)
Held to Maturity (HTM)	FVOCI (Equity)
Loans and Receivables	Amortized Cost

IFRS 9: Classification & Measurement – Debt Instruments Matrix

"Solely payment of principle and interest" i.e. plain vanilla?

Why are you holding the asset and how do you mange it?

	SPPI Test	Business Model Assessment	Comments
Amortized Cost	✓	Hold to Collect ✓	Pass SPPI & hold and collect
FVOCI (Debt)	✓	Hold to Collect and Sell ✓	Pass SPPI & hold to collect and sell
FVTPL	?	? FVTPL or other	Residual category

IFRS 9: Classification & Measurement – Business Model Assessment

- Level at which to perform the test
- Matter of fact rather than assertion

Business Model	Classification* (if Cash flow Characteristic Test also Passed)
Hold to collect business model	Amortized Cost
Hold to collect and sell business model	FVOCI (with recycling)
FVTPL business model	FVTPL

* Fair value option election available at initial recognition

IFRS 9: Classification & Measurement – Contractual Cash Flow Characteristics Test (SPPI)

- Solely Payments of Principle and Interest
  - Basic lending arrangement (i.e. “plain vanilla”)
- Primarily compensates for
  - Time value of money
  - Credit risk of counterparty

IFRS 9: Classification & Measurement – Debt Instrument Illustrative Examples

***Example* – Part A:**

Government A purchases a 5 year corporate bond with a fixed interest rate of 3%. The bond was purchased as part of the funds set aside to finance the construction of a new highway in 5 years. It intends to hold the instrument to maturity and collect on the cash flows.

The instrument was previously held as part of the held to maturity portfolio under IPSAS 29.

SPPI Test: ✔

Business Model: *Hold to Collect*

IFRS 9 Classification: Amortized Cost

IFRS 9: Classification & Measurement – Debt Instrument Illustrative Examples

***Example* – Part B:**

Government B purchases a 5 year corporate bond, interest rate variable based on market rates as part of a social security fund. The entity intends to hold the instrument to maturity and collect on the cash flows, but may sell as part of periodic rebalancing of the portfolio to better match the estimated timing and amount of future social security payments.

The instrument was previously classified as AFS under IPSAS 29.

SPPI Test: ✓

Business Model: *Hold to Collect and Sell*

IFRS 9 Classification: FVOCI (Debt)

IFRS 9: Classification & Measurement – Debt Instrument Illustrative Examples

***Example* – Part C:**

Government C purchases a 5 year corporate bond, interest rate variable based on market rates (same instrument from Part B).

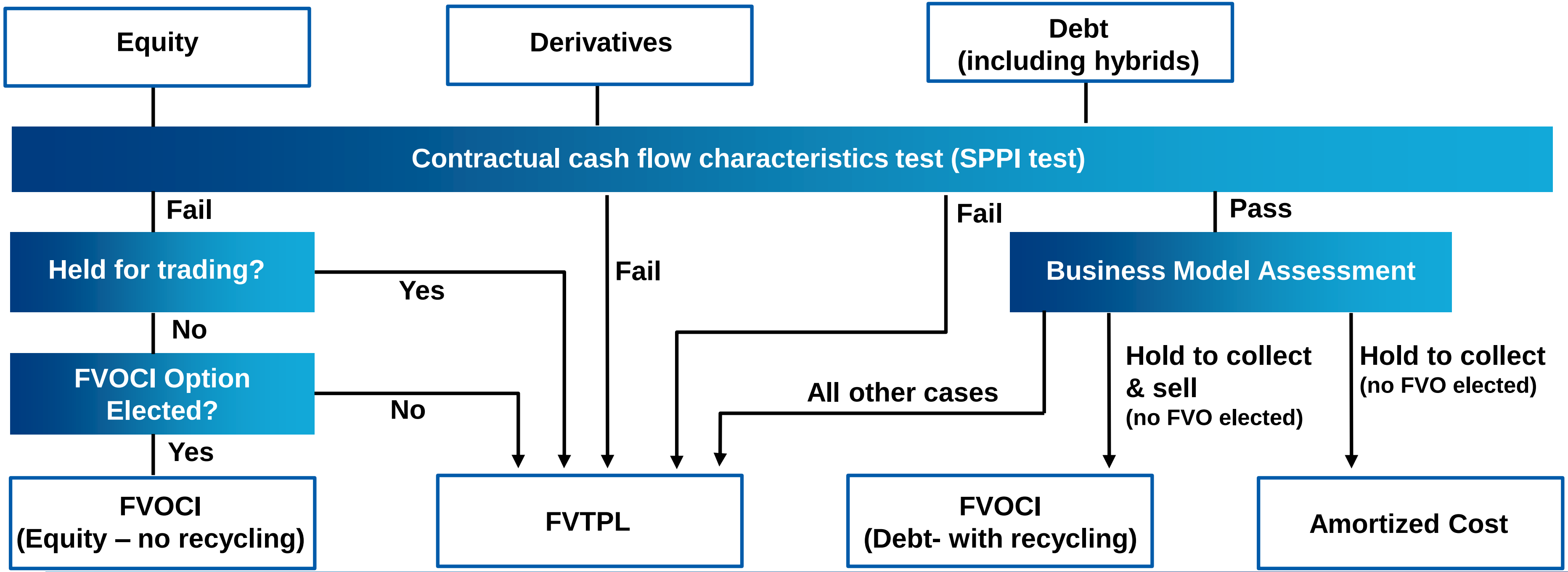
Converts into a fixed number of equity instruments of the issuer.

SPPI Test: ✖

Business Model: ?

IFRS 9 Classification: FVTPL

IFRS 9: Classification & Measurement – Roadmap for Financial Assets



IFRS 9: Classification & Measurement – Equity Instrument Illustrative Examples

***Example*:**

Government D controls through equity ownership, the local liquor distributor, for the purpose of regulating the liquor market. It does not intend to sell its investment in the foreseeable future. Government D produces separate financial statements.

1. *What options does Government D have in accounting for this investment?*

Equity method, cost, or FI

2. *Should Government D chooses to account for its equity investment as a financial instrument, what options are available?*

Is it held for trading? ✖

FVOCI election? **If yes, FVOCI (equity); If no, FVTPL**

IFRS 9: Classification & Measurement – Designations and Elections

- Designation as FVTPL
  - ➢ Eliminates accounting inconsistency; or
  - ➢ Part of a group of assets/ liabilities managed on a fair value basis
- Designation of non-derivative equity instruments as FVOCI
  - ➢ Irrevocable election at initial recognition
  - ➢ Subsequent fair value changes through OCI - never recycled to the P&L

IFRS 9: *Financial Instruments*

Phase II: Impairment

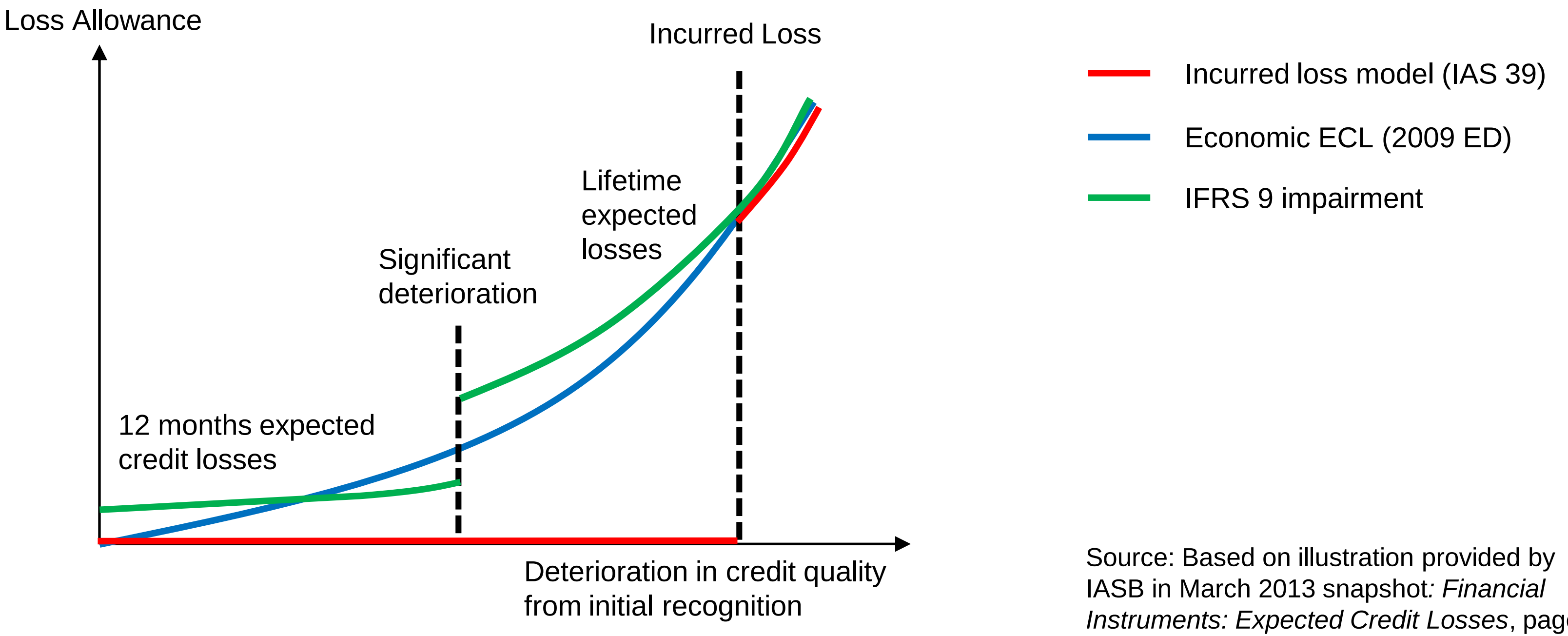
Impairment under IPSAS 29 – Incurred Loss Model

- Loss recognition based on objective evidence
- Assets held at Cost/ Amortized cost:
  - Impairment = carrying amount – PV of estimated future cash flows
  - Recognized in surplus/deficit
  - Reversals allowed
- AFS:
  - Impairment = cumulative loss recognized in net assets/equity
  - Reclass of loss from net assets/equity to surplus/deficit
  - Reversible for debt and non reversible for equity

IFRS 9: Impairment – Brief History and Background

- Criticism of the incurred loss model during financial crisis
- Forward looking expected loss model
  - Initial proposal – the credit adjusted Effective Interest Rate (EIR)
  - Decoupling of Expected Credit Losses (ECL) from EIR
- The dual measurement approach
  - Two-step model in 2013 ED – the Stepped Profile

IFRS 9: Impairment – the Stepped Profile



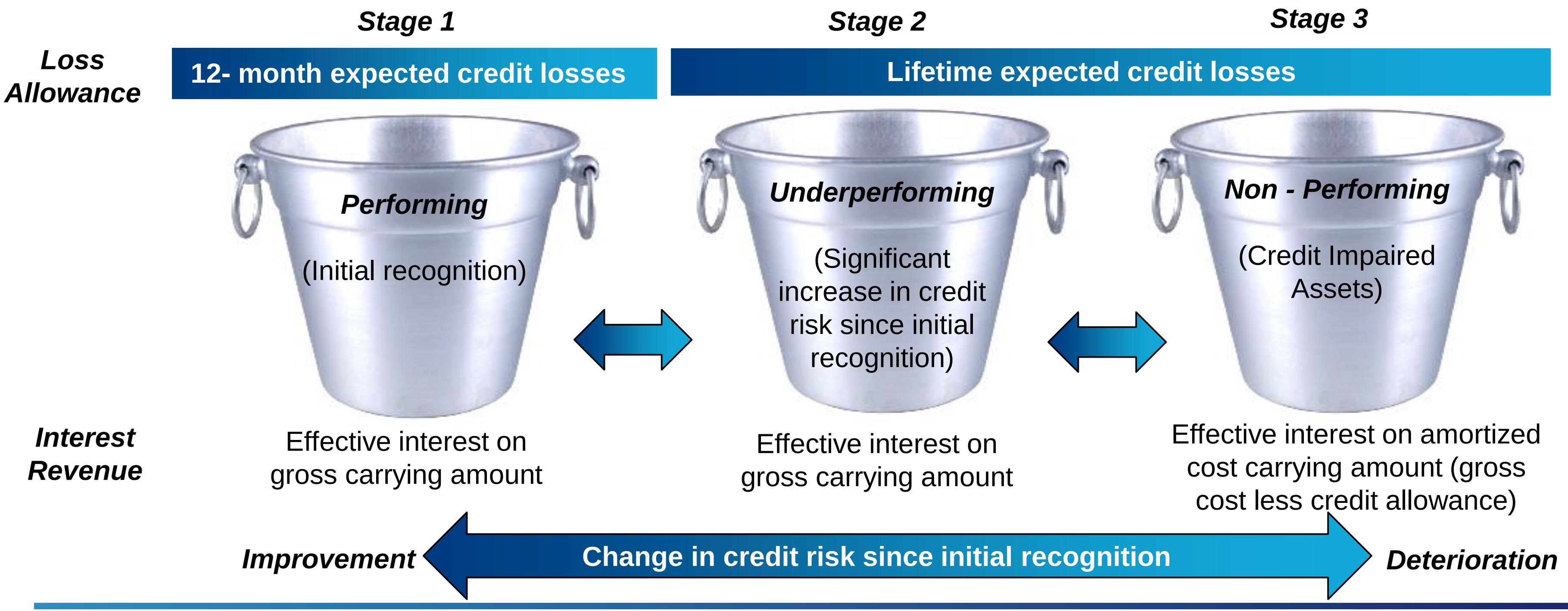
Source: Based on illustration provided by IASB in March 2013 snapshot: *Financial Instruments: Expected Credit Losses*, page 9

IFRS 9: Impairment – ECL Model

- IFRS 9 – 2 step expected credit loss model
  - ➢ Eliminates the incurred loss threshold for recognition of credit losses
  - ➢ ECL at inception and update for subsequent changes in credit risk
- Applies to debt instruments recorded at amortized cost or at FVOCI
- Expanded scope to include guarantees and loan commitments

Overall, the ECL is designed to:
- Ensure more timely recognition of ECLs than the existing incurred loss model
- Distinguish: instruments with significantly deteriorated credit quality and those without
- Better approximate the economic ECLs

IFRS 9: ECL Model – General Approach



IFRS 9: ECL Model – A Closer Look at Measurement

- What is ECL – Probability weighted estimate of credit losses
- Measurement – Lifetime vs 12 months
- Period over which to estimate ECL – Expected vs Contractual
- Information to consider – Reasonable and Supportable
- Modifications & Collateral

IFRS 9: ECL Model – Measurement Example

Company X originates a 10-year loan for $1,000,000. Interest paid annually. Loan's coupon and EIR are 5%.

Scenario A: No significant increase in credit risk since inception. Company X estimates:

- The loan has a 12 months probability of default (PD) of 0.5%; and
- The estimate of impact of loss given default (LGD) is 25%, and would occur in 12 months time if the loan were to default

Under IPSAS 29: No loss at inception. Impairment only recognized if and when loss event occurs e.g. $250,000 (25% x 1,000,000) in 12 months time if estimates are accurate

Under IFRS 9: 12 Month ECL at inception

Estimated cash flows receivable x PD x LGD, discounted at original EIR

= (1,000,000 + 50,000) x 0.5% x 25% /1.05

= **$1,250** → Continue to adjust and monitor for significant increase in credit risk

IFRS 9: ECL Model – Measurement Example

Company X originates a 10-year loan for $1,000,000. Interest paid annually. Loan's coupon and EIR are 5%.

Scenario B: Significant increase in credit risk since inception. Company X estimates:

- Loan has lifetime PD of 20%; and
- The LGD is 25% and would occur on average in 24 months time if the loan were to default

Under IPSAS 29: No loss at inception. Impairment only recognized if and when loss event occurs e.g. $250,000 (25% x 1,000,000) after 24 months when incurred

Under IFRS 9: Lifetime ECL

Estimated cash flows receivable x PD x LGD, discounted at original EIR

= (1,000,000 + 50,000) x 20% x 25% /1.05^2

= **$47,619** → as soon as significant increase in credit occurs. Continue to adjust based on updated facts & circumstances.

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IFRS 9: ECL Model – Implementing the General Approach

- Significant Increase in Credit Risk
  - Definition of default
  - Relative maturities
  - Individual vs. collective
  - Internal and external indicators
  - Qualitative vs. quantitative

IFRS 9: ECL Model – Simplified Approach

- Lifetime ECL at each reporting date from inception
- Required: Trade receivables without a significant financing component
- Optional: Trade receivables that contain a significant financing component; and all lease receivables

Overall: Intended to alleviate practical concerns of tracking changes in credit risk for entities with less sophisticated risk management systems

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IFRS 9: ECL Model – Purchased or Originated Credit- Impaired Financial Assets

- Credit impaired on purchase or origination, if evidence of impairment
- Credit adjusted EIR based on full lifetime ECL on initial recognition
- Subsequent changes in lifetime ECL (positive & negative) recognized in profit or loss

Overall: Need to consider interaction with existing guidance on concessionary loans

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IFRS 9: ECL Model – Example: Purchased or Originated Credit- Impaired Financial Assets

Company X issues a 10 year bond with annual coupon of $800 in arrears and principal of $10,000 repayable upon maturity. It was in significant distress and unable to pay coupon at the end of year 5. At the beginning of Year 6, Company Y estimates that the holder could expect to receive a single payment of $4,000 at the end of Year 7. Company Y purchases the bond at a price of $3,000 and determines it to be credit-impaired on initial recognition due to Company X's significant financial difficulty.

If instrument was not credit-impaired upon initial recognition:

- EIR = 70.1% (NPV of contractual cash flows of $800/yr until maturity + principal repayment of $10,000)
- Would recognize 12 month ECL at initial recognition & monitor subsequent changes in credit risk

In this case, credit-impaired upon purchase:

- EIR = 15.5% (NPV of $4,000 receivable in 2 years discounted at 15.5% = purchase price of $3,000)
- Carrying value of $3,000 and no ECL recognized at initial recognition
- Interest income = $464 ($3,000 x 15.5%) per annum
- If cash flows expected to be received increase/decrease at end of year, adjustment would be made to carrying value and recognized in profit & loss

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IFRS 9: ECL Model – Operational Simplifications

- Financial assets with low credit risk *(optional)*
- More than 30 days past due rebuttable presumption
- Change in 12-month risk of a default as approximation for change in lifetime risk

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What's Next?

- Other topics:
  - ➢ Public sector specific issues – securitizations
  - ➢ IFRS 7 *Financial Instruments: Disclosure*
  - ➢ IAS 32 *Financial Instruments: Presentation*
- *September Board Meeting*
  - ➢ General approach
    - New standard
    - Convergence project
    - Retention of public sector specific issues identified in IPSAS 28-30
  - ➢ NZASB ED for IFRS 9 Financial Instruments

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Questions?