IFRS 9 Financial Instruments

26 October 2018
Agenda

— Overview of requirements of IFRS 9
— Incorporation of forward looking information
— Considerations for modelling
— Changes in accounting policies and disclosures
— Are you ready? - Way forward
Your facilitators are...

Joseph Kariuki  Stephen Obock  Steve Yegon
Overview of IFRS 9
Effective date

Impact assessment & Considerations:
Operating model
Expected loss model
Data/systems and controls
Disclosures and reporting

Issue date
24 July 2014

Effective date
1 January 2018

TEST RUN

Early adoption permitted

2014 2015/2016 2017 2018

Interim reports
June Dec

Annual report
31 Dec 2018

No requirement to restate. Restate only if no hindsight

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Overview of IFRS 9

**Classification and measurement**
- Business model assessment (held to collect/sell)
- Solely Payments of Principal and Interest: ‘SPPI test’

**Impairment**
- Expected credit loss
- Definition of default
- ‘Staging’ criteria
- Economic scenarios

**Hedging**
- Limited analysis and impact

**Technical considerations**
- Portfolio segmentation
- Leverage
- Prepayment/extension options
- Contractually-linked instruments

**Key considerations**
- Portfolio segmentation
- Long outstanding trade receivables?
- Quality of data?

**Technical treatment**
- Re-designation of assets to either:
  - Amortised Cost
  - FVOCI
  - FVTPL

- Impairment
- Move from incurred loss to:
  - Lifetime expected credit loss
  - 12-month expected credit loss

- Limited relaxation of hedge accounting rules

**FVOCI**: Fair value through other comprehensive income (equity)
**FVTPL**: Fair value through profit and loss
Overview - Classification & Measurement

IFRS 9 introduces a two-step approach to determine the classification of financial assets:
1. Business model assessment and
2. Solely payments of principal and interest (‘SPPI’) assessment

**Business model**
- Considers how financial assets are managed to generate cash flows
- Assessed at portfolio level (not instrument level)
- Sub-division of portfolios may be appropriate

**Examples of key challenges:**
- Assessment of impact of sales activity
- Data needed for analysis of historical sales
- Prospective view
- Securitisation activities

**SPPI**
- Considers whether contractual cash flows are consistent with a basic lending arrangement
- Principal = initial fair value of financial asset
- Interest = consideration for time value of money and credit risk

**Judgemental aspects:**
- Prepayment/extension options
- Receivables with significant financing component
- Leverage
- Contractually linked instruments
C&M: IAS 39 versus IFRS 9

<table>
<thead>
<tr>
<th>IAS 39 Category</th>
<th>IFRS 9 Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value</td>
<td>Fair value</td>
</tr>
<tr>
<td>Available for sale</td>
<td>Fair value through other comprehensive income</td>
</tr>
<tr>
<td>Held to maturity</td>
<td>Amortised cost</td>
</tr>
<tr>
<td>Loans and receivables</td>
<td>SPPI test</td>
</tr>
</tbody>
</table>

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Financial asset - Equity & Derivatives

Equity Instrument

Held for trading?

Yes

OCI option?

No

FVTPL

- No cost exemption

Yes

FVOCI

- Irrevocable – decision made on investment by investment basis and not portfolio basis
- Changes in fair value presented in OCI
- Dividends generally recognised in P&L
- No reclassification of gains and losses into P&L on disposal and no impairment recognised in P&L
Financial asset classification - Debt instruments

Debt instrument

- Are the asset’s contractual cash flows solely payments of principal and interest (SPPI)?
  - No
  - Yes

  - Is the business model’s objective to hold to collect contractual cash flows?
    - No
    - Yes

    - Is the business model’s objective both to collect contractual cash flows and to sell?
      - No
      - Yes

FVTPL *

FVOCI * (Recycle to p&l when asset is sold)

Amortised cost *

* FVTPL is available to eliminate or significantly reduce accounting mismatch
Overview - IFRS 9 Expected Credit Loss

- **IAS 39**
  - **Lifetime expected losses**
  - Key judgment around 'significant increase in credit risk', definition of default

- **Forward looking**
  - Losses include the impact of future economic forecasts.

- **Relative assessment**
  - Required to track historical credit assessments back to when facilities granted.

- **Off balance sheet exposures**
  - Required to provide ECL on loan commitments and financial guarantees.

- **IFRS 9**

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Impairment - the new model

Expected loss model

- Past events
  - Current conditions
    - Forecast of future economic conditions

Reasonable & supportable information that is available without undue cost or effort
Forward looking information
Incorporating forward looking information

1. Data Input
2. Model Selection
3. Model Fit
4. Application to PD

- Data Preparation
- Variable Selection
- Variables Forecasting
- Forecast PDs
Incorporating forward looking information

1. Identify the relevant macro-economic factors and obtain the historical figures

   - GDP
   - Exchange Rate
   - Employment Indicator
   - Macroeconomic factors
   - Stock Index
   - Interest Rate

2. Assess the how the modelled historical loss rates have changed relative to the change in each of the relevant macroeconomic factors

<table>
<thead>
<tr>
<th>Year</th>
<th>Loss rates</th>
<th>Δ GDP</th>
<th>Δ FX rate</th>
<th>Δ Interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.31%</td>
<td>1.70%</td>
<td>2.04%</td>
<td>2.94%</td>
</tr>
<tr>
<td>2</td>
<td>0.18%</td>
<td>1.40%</td>
<td>1.68%</td>
<td>2.42%</td>
</tr>
<tr>
<td>3</td>
<td>0.55%</td>
<td>3.70%</td>
<td>4.44%</td>
<td>6.39%</td>
</tr>
<tr>
<td>4</td>
<td>0.08%</td>
<td>0.50%</td>
<td>0.60%</td>
<td>0.86%</td>
</tr>
<tr>
<td>5</td>
<td>0.47%</td>
<td>1.10%</td>
<td>1.32%</td>
<td>1.90%</td>
</tr>
</tbody>
</table>

3. Estimate an empirical, statistical relationship between the portfolio loss rates and macroeconomic variables.

4. Maintain only variables with significant coefficients and expected sign expected under the working hypotheses.
Forward looking information

5. Forecast the statistically significant macroeconomic factors over a 12 month period from the reporting date.

6. Using the empirical equation, compute the applicable forward – looking adjustment based on the forecasted macroeconomic factors.

7. Apply the computed adjustments to the baseline PD / loss rate to obtain the forecasted loss rate.
Impairment Modelling
**IFRS 9 provisioning for receivables**

**IFRS 9 includes the following simplifications for impairment of trade receivables, contract assets and lease receivables:**

<table>
<thead>
<tr>
<th>Situation</th>
<th>Proposed Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade receivables and contract assets of one year or less or those without a significant financing component.</td>
<td>Recognize a loss allowance at an amount equal to lifetime expected credit losses.</td>
</tr>
<tr>
<td>Trade receivables and contract assets without a significant financing component.</td>
<td>Simplified approach of recognizing lifetime expected loss.</td>
</tr>
<tr>
<td>Lease receivables</td>
<td>Accounting policy choice to measure the loss allowance at an amount equal to lifetime expected credit loss.</td>
</tr>
</tbody>
</table>

**NB:** Entities are not required to determine whether credit risk has increased significantly since initial recognition.
IFRS 9 standard does not prescribe how an entity should estimate lifetime expected credit losses (ECL) for receivables but proposes a provision matrix approach.

Provision Matrix
- Ageing of receivables
- Segmentation (optional)
- Development of a provision matrix
- Incorporation of forward looking information.

Single loss rate approach
- Determine an average historical loss rate as a proportion of uncollected amounts to the total balance of trade receivables
- Incorporation of forward looking information.
Provision matrix/flow rate matrix approach

Step 1: Collect receivables aging and calculate the flow rate

In this step, the entity collects periodic receivables aging reports and calculates a flow /transfer rate. Flow rate represents the probability of a receivable moving into the next aging bucket in the subsequent period. This calculation is performed periodically in line with business practice.

<table>
<thead>
<tr>
<th>Trade receivables aging (ETB)</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 – 30 days</td>
<td>20,000</td>
<td>19,750</td>
<td>23,500</td>
<td>21,250</td>
</tr>
<tr>
<td>31 – 60 days</td>
<td>10,340</td>
<td>9,800</td>
<td>8,750</td>
<td>10,100</td>
</tr>
<tr>
<td>61 – 90 days</td>
<td>5,120</td>
<td>4,300</td>
<td>3,900</td>
<td>4,150</td>
</tr>
<tr>
<td>91 + days</td>
<td>1,400</td>
<td>1,350</td>
<td>1,490</td>
<td>1,390</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Flow rate</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 30 days</td>
<td>49%</td>
<td>44%</td>
<td>43%</td>
</tr>
<tr>
<td>31 - 60 days</td>
<td>42%</td>
<td>40%</td>
<td>47%</td>
</tr>
<tr>
<td>61 - 90 days</td>
<td>26%</td>
<td>35%</td>
<td>36%</td>
</tr>
<tr>
<td>91+ days</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>
Step 2: Calculate the loss rate

A loss rate is calculated for each bucket. The calculated loss rate represents the probability that the receivables in a given bucket will reach the 91+ days category. This example assumes that the 91+ days balance is equal to the actual historical loss.

<table>
<thead>
<tr>
<th>Flow rate</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 30 days</td>
<td>49%</td>
<td>44%</td>
<td>43%</td>
</tr>
<tr>
<td>31 - 60 days</td>
<td>42%</td>
<td>40%</td>
<td>47%</td>
</tr>
<tr>
<td>61 - 90 day</td>
<td>26%</td>
<td>35%</td>
<td>36%</td>
</tr>
<tr>
<td>91+ days</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Loss rate</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 30 days</td>
<td>5%</td>
<td>6%</td>
<td>7%</td>
<td>6%</td>
</tr>
<tr>
<td>31 - 60 days</td>
<td>11%</td>
<td>14%</td>
<td>17%</td>
<td>14%</td>
</tr>
<tr>
<td>61 - 90 day</td>
<td>26%</td>
<td>35%</td>
<td>36%</td>
<td>32%</td>
</tr>
<tr>
<td>91+ days</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>
The calculation of the expected credit loss is as illustrated below using both provision matrix and single loss rate approaches:

**ECL computation illustration for provision matrices approach**

<table>
<thead>
<tr>
<th>Financial Asset</th>
<th>Bucket</th>
<th>Historical PD</th>
<th>FLI Adjustment</th>
<th>Adjusted PD</th>
<th>Exposure as on 31 Dec 2017</th>
<th>ECL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade receivables</td>
<td>0 - 30 days</td>
<td>6%</td>
<td>-1.05%</td>
<td>5.94%</td>
<td>2,000,000</td>
<td>118,800</td>
</tr>
<tr>
<td></td>
<td>31 - 60 days</td>
<td>14%</td>
<td>-1.05%</td>
<td>13.85%</td>
<td>1,000,000</td>
<td>138,500</td>
</tr>
<tr>
<td></td>
<td>61 - 90 days</td>
<td>32%</td>
<td>-1.05%</td>
<td>31.67%</td>
<td>300,000</td>
<td>95,010</td>
</tr>
<tr>
<td></td>
<td>91+ days</td>
<td>100%</td>
<td>100.00%</td>
<td>100.00%</td>
<td>900,000</td>
<td>900,000</td>
</tr>
</tbody>
</table>

The expected credit loss model above assumes a write-off threshold of 90 days.
Single loss rate approach

Step 1: Define an appropriate default trigger

For the simplified approach, it is critical to have a default definition that is in line with internal business practices.

Step 2: Calculate loss rate/ recovery rate per period

Depending on the data, there are two ways of computing the loss rate per period. A loss rate may be computed as the ratio of outstanding invoice amounts beyond the default period and raised invoices at the beginning of each period.

In the case where payments are available, the recovery rate may be computed as a ratio of payments made on bills raised per time period before the default date. The loss rate is then obtained as $1 - \text{Recovery rate}$. A common approximation is to cap recovery rates at 100% where payments exceed invoice amounts.

<table>
<thead>
<tr>
<th>Origination month</th>
<th>Bills</th>
<th>Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>201201</td>
<td>1,000,000.00</td>
<td>900,000.00</td>
</tr>
<tr>
<td>201202</td>
<td>2,000,000.00</td>
<td>1,400,000.00</td>
</tr>
<tr>
<td>201203</td>
<td>1,500,000.00</td>
<td>1,100,000.00</td>
</tr>
<tr>
<td>201204</td>
<td>1,800,000.00</td>
<td></td>
</tr>
<tr>
<td>201205</td>
<td>1,200,000.00</td>
<td>1,750,000.00</td>
</tr>
<tr>
<td>201206</td>
<td>1,900,000.00</td>
<td>1,000,000.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Recovery rate</th>
<th>Loss rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>90.00%</td>
<td>10.00%</td>
</tr>
<tr>
<td>70.00%</td>
<td>30.00%</td>
</tr>
<tr>
<td><strong>73.33%</strong></td>
<td>26.67%</td>
</tr>
<tr>
<td>97.22%</td>
<td>2.78%</td>
</tr>
</tbody>
</table>

The single loss rate is computed as a simple average of all loss rates per period.
Changes in accounting policies and disclosures
Implementation of IFRS 9

Increased data and qualitative and quantitative disclosure requirements

Transition disclosures

- IAS 8 Accounting policies, changes in accounting estimates and errors
- IFRS 7.42I-S Initial application of IFRS 9

BAU disclosures

- IFRS 7 Financial instruments: Disclosures
## Transition disclosures

<table>
<thead>
<tr>
<th>Type</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Quantitative disclosures</strong></td>
<td>For each class of financial assets and liabilities:</td>
</tr>
<tr>
<td></td>
<td>- Original measurement category and carrying amount as per IAS 39</td>
</tr>
<tr>
<td></td>
<td>- New measurement category and carrying amount as per IFRS 9</td>
</tr>
<tr>
<td></td>
<td>- Amount in the SOFP that were previously designated as measured at FVTPL</td>
</tr>
<tr>
<td></td>
<td>but were no longer so designated</td>
</tr>
<tr>
<td></td>
<td>- Amount of the adjustment for each financial statement line affected,</td>
</tr>
<tr>
<td></td>
<td>and for basic and diluted EPS for current period and each prior period</td>
</tr>
<tr>
<td></td>
<td>presented</td>
</tr>
<tr>
<td></td>
<td>- Amount a change in accounting estimate has an effect in the current</td>
</tr>
<tr>
<td></td>
<td>period or is expected to have an effect in future periods</td>
</tr>
<tr>
<td></td>
<td>- Reconciliation of the ending impairment allowances under IAS 39 and</td>
</tr>
<tr>
<td></td>
<td>the provisions under IAS 37 to the opening loss allowances under IFRS 9</td>
</tr>
<tr>
<td><strong>Qualitative disclosures</strong></td>
<td>The title of the IFRS</td>
</tr>
<tr>
<td></td>
<td>- Nature of the change in accounting policy</td>
</tr>
<tr>
<td></td>
<td>- Description of the transitional provisions</td>
</tr>
<tr>
<td></td>
<td>- How it applied the classification requirements in IFRS 9 to those</td>
</tr>
<tr>
<td></td>
<td>financial assets whose classification has changed as a result of</td>
</tr>
<tr>
<td></td>
<td>applying IFRS 9</td>
</tr>
<tr>
<td></td>
<td>- The reasons for any designation or de-designation of financial assets</td>
</tr>
<tr>
<td></td>
<td>or financial liabilities measured at FVTPL</td>
</tr>
</tbody>
</table>
Questions
Why is this important?

- Most companies lease assets.
- Under IFRS 16, lessees will bring all leases on balance sheet.
- New lease definition becomes the new on/off-balance sheet test.
- Changes many financial ratios.
- Your stakeholders/investors will want to understand the impact on your business.
Agenda

1. Major impacts for lessees
2. New definition, new accounting
3. Next steps
4. Key points to remember
Major impacts for lessees
Lessees face major changes

Leases on balance sheet

Balance sheet

Asset
= ‘Right-of-use’ of underlying asset

Liability
= Obligation to make lease payments

P&L

Lease expense
Depreciation
+ Interest
= Front-loaded total lease expense

Operating leases previously off-balance sheet will now be on balance sheet
Impact on Balance sheet and profit or loss

 Companies with operating leases will appear to be more asset-rich, but also more heavily indebted

Total lease expense will be front-loaded even when cash rentals are constant

- Asset
- Liability
- Depreciation
- Interest
- Cash rental payments
Impact on financial ratios

- **Profit/loss**: EBITDA
- **Balance sheet**: Total assets
- **Ratios**: Gearing
- **EPS (in early years)**: Net assets
- **Interest cover**: Asset turnover
New definition, new accounting
Lease definition

The new on/off-balance sheet test for lessees – a key judgement area

<table>
<thead>
<tr>
<th>New standard</th>
<th>Old standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>ON Lease</td>
<td>OFF Service</td>
</tr>
<tr>
<td>Finance lease</td>
<td>Operating lease</td>
</tr>
</tbody>
</table>
A lease is a contract that conveys the right to use an asset for a period of time in exchange for consideration.

Definition focuses on control over the use of an identified asset.
 Lease definition - Exemptions

Two major optional exemptions make the standard easier to apply

- **Short term leases**
  - $\leq 12$ months

- **Leases of low value items**
  - Judgement!!
Measuring the lease liability

Lease liability = Present value of lease rentals + Present value of expected payments at end of lease

Key inputs:
- Lease term
- Lease payments
- Discount rate

Significant judgement area
Measuring the right-of-use (ROU) asset

\[
\text{ROU asset} = \text{Lease liability} + \text{Initial increment direct costs} + \text{Prepaid lease payments} + \text{Costs to dismantle or restore (IAS 37)} - \text{Lease incentives}
\]
Lessor accounting

Lessor accounting remains similar to current practice (IAS 17)

but lacks consistency with new lessee accounting model

- Lease classification test: ✔
- Finance leases and operating leases: ✔
- Consistent accounting model for lessors and lessees: ✗
Sale-and-leaseback

IFRS 16 essentially **kills sale-and-leaseback as an off-balance sheet financing structure**

If it is a sale:
- Measure ROU asset at the retained portion of the previous carrying amount of the asset
- Recognise a gain or loss related to the rights transferred to the lessor
Effective date

Early adoption permitted if IFRS 15 is adopted

Effective date
1 January 2019

Annual report
31 December 2019

Interim report

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Next steps
Initial discussion points

- Discuss initial thoughts on the expected impact of IFRS 16.
- Highlight non-accounting areas potentially affected.
- Planned communications with external stakeholders.

Next steps

- Start impact assessment
- Early adoption?
- Transition approach?
Disclosure prior to effective date

- IAS 8.30 disclosure — known/reasonably estimable possible impact of IFRSs issued but not yet effective.

Considerations

- Pre-adoption disclosures progressing in level of detail as your application date approaches?
- Pre-adoption disclosures meeting external stakeholder expectations?
Key points to remember
Key points to remember

- **New leases standard will impact most companies.**
- **Process of assessing impact should start now.**
- **KPMG has set up a team to assist companies implement the standard.**
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