Agenda

- Background
- Classification and Measurement
- Expected Credit Losses
- Hedge accounting
- Disclosures
- Business Impacts and Next Steps
- Key Points to Remember
Overview of IND AS 109

- Substantial changes from existing standards initiated post the 2008 financial crisis
- Initial aim was to address shortcomings of existing standards
  - Complexity
  - Too little too late
- New categories and classification criteria introduced
- Single impairment model
- Expected loss provisions
- Simplified hedge accounting rules
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### Main Changes From Previous Guidance

#### Financial asset measurement categories

- Measurement bases: Amortised Cost, FVOCI* and FVTPL* remain.
- However, criteria for classifying assets as Amortised Cost, FVOCI and FVTPL have been significantly changed.
- Derivatives embedded in a financial asset are not separated – the whole asset is assessed for classification.

* FVOCI – fair value through other comprehensive income / FVTPL – fair value through profit or loss

#### Financial liability measurement categories

- IND AS 109 retains almost all of the existing requirements.
- Change: gain or loss on a financial liability designated at FVTPL attributable to changes in own credit risk generally presented in OCI with remaining change in fair value presented in profit or loss.
Are the asset’s contractual cash flows solely payments of principal and interest (SPPI)?

- Yes
  - Is the business model’s objective to hold to collect contractual cash flows?
    - Yes
      - Amortised cost *
    - No
      - FVOCI*
- No
  - Is the business model’s objective both to collect contractual cash flows and to sell?
    - Yes
      - FVTPL
    - No
      - FVOCI*

* Subject to FVTPL designation option - if it reduces accounting mismatch
The Solely P&I (SPPI) Criterion

Do the cash flows consist only of principal and interest?

- Consistent with a basic lending arrangement.

<table>
<thead>
<tr>
<th>Principal</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>Consideration for time value of money, credit risk, other basic lending risks (such as liquidity risk); other associated costs (such as administrative costs); and a profit margin.</td>
</tr>
</tbody>
</table>
### Business Model Assessment

<table>
<thead>
<tr>
<th>Business model</th>
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</thead>
<tbody>
<tr>
<td>Hold to collect contractual cash flows</td>
</tr>
<tr>
<td>Hold both to collect contractual cash flows and for sale</td>
</tr>
<tr>
<td>Other business models</td>
</tr>
</tbody>
</table>

- Assessment considerations: how performance is evaluated, how risks are managed, how managers are compensated, actual and expected levels of sales, etc.
- Assessed at a level at which assets are managed, e.g. portfolios.
Company Z generates trade receivables that are due in 30 days after the issue of an invoice.

Z manages cash collections, deals with customer queries and sends out reminders when amounts become overdue.

The management focuses on monitoring the overdue status and collection teams are evaluated on the basis of the length of the cash collection period.

When a receivable is overdue by 150 days and no payment plan has been agreed with a customer, Z’s policy is to sell the receivable, at a significant discount, to a debt collection company and Z has no further involvement with that receivable. This happens rarely.

Q: What is the business model in which trade receivables are held?
Business Model Assessment: Rationale

Hold to collect contractual cash flows.

- Management of risk
  - Focus on collection of contractual cash flows and management of overdue status.
  - The collection team evaluated with reference to the collection period.

- Sales of assets
  - Infrequent sales in response to deterioration in credit risk are not inconsistent with the Hold to collect model.
Principles of Financial Asset Classification – Equity Instruments

Equity instrument

Held for trading?

Yes

OCI option?

No

No

Yes

FVOCI*

FVTPL

* amounts recognised in OCI are not reclassified to profit or loss on derecognition and no impairment loss recognised in profit or loss.
Classification of financial liabilities

- Fair value option and presentation of credit risk changes
- No transfers to P&L even for realised gains or losses on changes in credit risk
- Exceptions to split presentation
  - If split presentation would create or enlarge and accounting mismatch in profit or loss
  - If the financial liability is a loan commitment or financial guarantee contract
- Deletion of cost exception for derivative financial liabilities
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Main Changes From Current Guidance

Expected credit losses

- IND AS 109 changes accounting for impairment - impairment losses recognised for all amortised cost and FVOCI assets, not only those where credit loss has been incurred.

The model also applies to certain financial guarantees and loan commitments, but not to equity investments or instruments measured at FVTPL.
Under the general principle, one of two measurement bases will apply:
- 12-month expected credit losses; or
- lifetime expected credit losses.

The measurement basis would depend on whether there has been a significant increase in credit risk since initial recognition.
General approach to impairment

- Day one loss
- Impact compared to current practices
- IASB fieldwork results
- Application in business combinations
- Impact on volatility of reported earnings
- Differences of definitions in practice
  - 12 month expected losses
  - Default events
  - Significant increase in credit risk
Trade and Lease Receivables and Contract Assets

- Lease receivables
- Trade receivables and contract assets with a significant financing component
- Trade receivables and contract assets without a significant financing component

Policy election to apply

General approach

Simplified approach

Loss allowance always equal to lifetime expected credit losses.

Practical expedient to calculate expected credit losses – provision matrix.
Loss Allowance Recognition: Illustration

- On 31 December 20X1 Bank B grants a loan to a borrower with low credit standing, but still at an acceptable level for B.
- The price of the loan does not reflect incurred credit losses.

Q: What loss allowance should B recognise in the statement of financial position at 31 December 20X1?

A. None.
B. 12-month expected credit losses.
C. Lifetime expected credit losses.
Loss Allowance Recognition: Rationale

B. 12-month expected credit losses.

- Under the general model of IND AS 109, all assets need to have a loss allowance.
- Allowance covers either 12-month or lifetime expected credit losses depending on whether the asset’s credit risk has increased significantly.
- Since the loan has just been granted and there has not been a significant increase in credit risk, an allowance equal to 12-month expected credit losses is appropriate.
Practical considerations

- Use of external ratings to determine whether credit risk is low
- Low LGD does not obviate the need to consider the need for lifetime expected losses
- 30 day rebuttable measure
- Information available without undue cost or effort
- Modified financial assets
- Reclassifications of assets
The measurement of expected losses should reflect

- An unbiased and probability weighted amount
- The time value of money
- Reasonable and supportable information that is available without undue cost or effort

There is no practical expedient to measure impairment at fair value
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Many Existing Concepts Retained

- Three hedge accounting models:
  - Fair value hedge.
  - Cash flow Hedge.
  - Hedge of a net investment.
- Hedge documentation requirements.
- Measurement of hedged items and hedging instruments.
- Measurement of ineffectiveness.
More Principles-based

- 80%-125% effectiveness bright-line removed.
- No retrospective testing of effectiveness. In some cases only qualitative prospective effectiveness test will be required.
- More items are allowed as hedged items, for example:
  - risk components of non financial items; and
  - net positions.
- More items allowed as hedging instruments, for example:
  - Non-derivative financial instruments measured at FVTPL.

In many instances hedge accounting will be less burdensome and there will be more scope to reflect internal risk management strategies.
Some New Complexities

- Explicit requirements for hedge accounting to align with an entity’s risk management objective.
- Hedge accounting cannot be voluntarily discontinued.
- Introduction of a concept of “rebalancing”.
- Potentially complex accounting for portions of derivatives excluded from hedging relationships (e.g. time value of an option).
Update on Macro Hedging project

- Potentially introducing fundamental change in how risk management is considered for financial reporting.
- A Discussion Paper (DP) *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* has been published with a comment deadline of October 2014.
- The DP puts forward a ‘portfolio revaluation approach’, which is similar to the fair value hedge model.
- The next step in the process will be for the IASB to consider responses to the DP.
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IND AS 109 introduces extensive new disclosure requirements.

Sourcing the additional information required could be a complex and time-consuming process that will have an impact on resources and systems.
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Business Impacts

- Judgements – new complexities and wider scope.
- Significant impact on systems and processes.
- Impact on equity and KPIs.
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Key Points to Remember!

- IND AS 109 will impact entities in different ways:
  - Banks, insurers and other financial sector entities are likely to be significantly impacted.
  - Impact on other corporates may be less.
- Process of assessing impact should start now.
Thank you