IFRS 9 - RISK ASSESSMENT

FINANCIAL INSTRUMENTS

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OUTLINE OF THIS WEBINAR

- Financial Instruments
  - Classification and Measurement
  - Impairment
  - Hedging
- Risk Assessment - identify areas that will require:
  - Significant effort or judgement (information gathering, types and features of instruments)
  - Changes to financial reporting and accounting systems
  - Communication

INTRODUCTION

TRANSITION

Timeline - 30 June Year End

1 July 2017

1 July 2018

30 June 2019

Comparative period

Today

First day of Comparative Period

Date of Initial Application

Mandatory application of IFRS 9

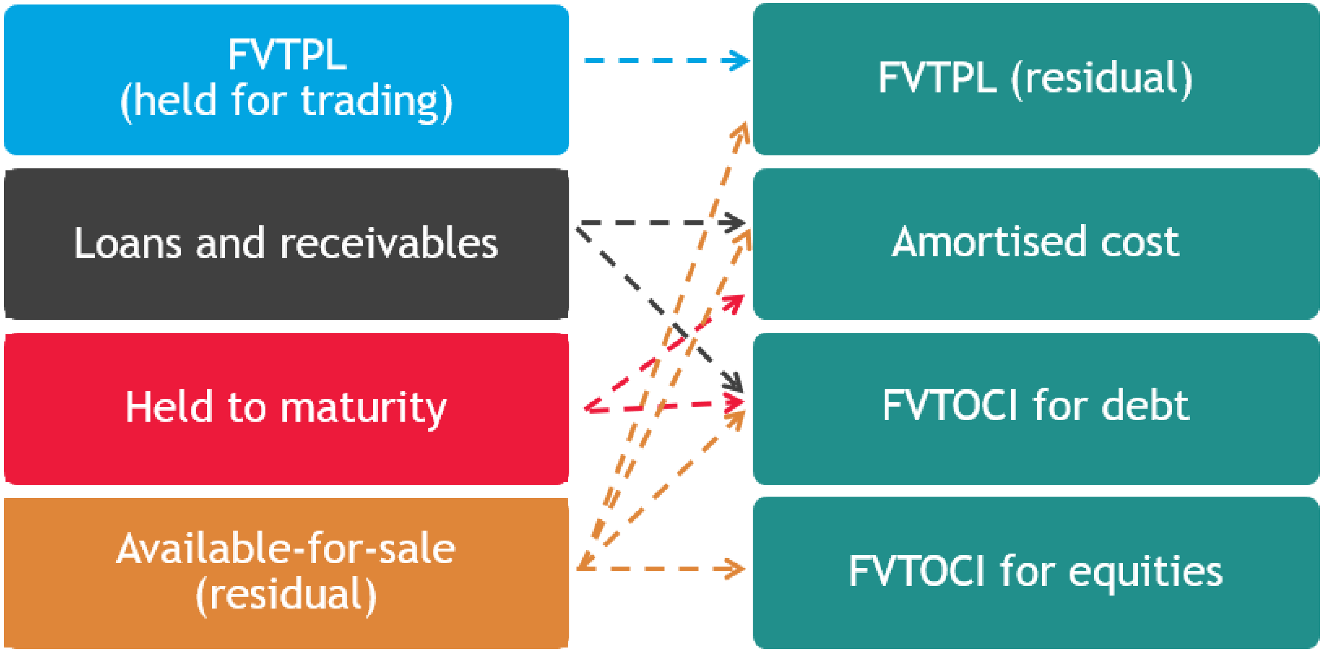
MONTHLY FINANCIAL REPORTING WEBINARS

- https://www.bdo.com.au/en-au/insights/audit-assurance/webinars/2018-financial-reporting-accounting-standards

- Previous Webinar's dealing with IFRS 9
  - Transition (June 2018)
  - Classification and Measurement (March 2017)
  - Impairment (April 2017)
  - Hedging (December 2017)

CLASSIFICATION AND MEASUREMENT

CLASSIFICATION - CHANGES FROM IAS 39



CLASSIFICATION – IFRS 9

CASHF LOW TYPE	BUSINESS MODELS: HOLD TO COLLECT	HOLD TO COLLECT & SELL	OTHER
SOLEY PAYMENTS OF PRINCIPAL & INTEREST (SPPI)	AMORTISED COST	FVTOCI*	FVTPL
OTHER	FVTPL	FVTPL	FVTPL

* One-off irrevocable election exists for investment in equity investments not held for trading

BUSINESS MODEL

- How management manages financial assets to collect cash
- Matter of fact / observable
- Gather information at the business model level:
  - How financial assets and performance of the business model are evaluated and reported to key management personnel
  - How risks are managed in the business model (and the entity)
  - How managers are compensated

SPPI

- Contractual cash flows = solely payment of principle and interest on the principal on specified dates
- Interest comprises compensation for credit risk, time value of money, sometimes liquidity, profit margin and admin costs
- Basic lending arrangements
- Identify and consider features that introduce exposures to risks or volatility that are unrelated to basic lending arrangements

RISK ASSESSMENT

- Identify features that introduce risk and volatility into contractual cash flows
- Understand model that governs management of cash flow collections
- Valuation approach and inputs to fair value
- Communication about volatility in profit or loss

IMPAIRMENT

CLASSIFICATION

		BUSINESS MODELS		
		HOLD TO COLLECT	HOLD TO COLLECT & SELL	OTHER
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IMPAIRMENT – GENERAL APPROACH

Stage 1	Stage 2	Stage 3
Strong capacity to meet	>30 days past due*	>90 days past due*
PERFORMING	UNDER-PERFORMING	NON-PERFORMING
12-month Expected Credit Losses (ECL) recognised	***Lifetime*** ECL recognised	***Lifetime*** ECL recognised
Interest revenue on gross carrying amount	Interest revenue on gross carrying amount	Interest revenue on net carrying amount (i.e. net of credit allowance)

← Change in credit risk (i.e. risk of default) since initial recognition →

EXAMPLE

- A loan = $ 1m with a 5 % interest, repayable in 2 years time
- At end of year 1, borrower has indicated it will only repay at end of year 3 and no interest will be paid for year 3
- Calculate impairment loss at end of year 1 (assuming no change in credit risk)

EXAMPLE

- Loan if paid on time:

	Year 1	Year 2	Total
Cash flows due at initial recognition	$50,000	$1,050,000	$1,100,000
Discount factor	0.9524 (1/1.05)	0.9070 (1/1.05^2)	
PV	$47,619	$952,381	$1,000,000

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EXAMPLE

- Credit loss with repayment changes

  = $ 1,000,000 (previous slide) - $ 956,808 (below) = $ 43,192
- Entity assumes this has a 30% chance of occurring

	Year 1	Year 2	Year 3	Total
Expected cash flows	$50,000	$50,000	$1,000,000	$1,100,000
Discount factor	0.9524 (1/1.05)	0.9070 (1/1.05^2)	0.8638 (1/1.05^3)	
PV	$47,619	$45,351	$863,838	$956,808

EXAMPLE

- Entity thinks this is more likely to occur:

	Year 1	Year 2	Year 3	Year 4	Total
Expected cash flows	\$50,000	\$50,000	NIL	\$1,000,000	\$1,100,000
Discount factor	0.9524 (1/1.05)	0.9070 (1/1.05^2)	0.8638 (1/1.05^3)	0.8227 (1/1.05^4)	
PV	\$47,619	\$45,351	NIL	\$822,702	\$915,673

EXAMPLE

- Therefore, ECL are calculated as follows:

	Chance of recovery scenario occurring (weighting)	Contractual cash flows due end of Year 2	PV	Credit loss	Weighted average ECL
	A	B	C	D = B - C	A x D
Scenario 1	30%	$1,000,000	$956,808	$43,192	$12,597
Scenario 2	70%	$1,000,000	$915,673	$84,327	$59,029
	100%				$71,986

EXAMPLE

- Entity then estimates the probability of default <u>over the life</u> is as follows:

Scenario 1 (base case)	70%	No default
Scenario 2 (best case)	4%	No default
Scenario 3 (worst case)	26%	Default

EXAMPLE

- And estimates that the probability of the default occurring in the next 12 months = 4%

Scenario	Probability	Default outcome
Scenario 1 (base case)	90%	No default
Scenario 2 (best case)	6%	No default
Scenario 3 (worst case)	4%	Default

EXAMPLE

- Therefore:

  Lifetime ECL = $ 71,986 x 26% = $ 18,716

  12-month ECL = $71,986 x 4% = $ 2,879

RISK ASSESSMENT

- Gather information / data that is reasonable and supportable (historical and forward looking)
- Prepare calculation that is appropriate for level of credit risk assessment
- Incorporates unbiased, probability weighted default consideration(s) and the time value of money (general approach)
- Consider impact on financial reporting and accounting systems

IMPAIRMENT – SIMPLIFIED APPROACH

	Expected default rate	Gross carrying amount	Credit loss allowance (Default rate x Gross carrying amount)
Current	0.5%	CU16,000,000	CU80,000
1-30 days past due	1.8%	CU8,000,000	CU144,000
31-60 days past due	3.8%	CU5,000,000	CU190,000
61-90 days past due	7.0%	CU3,500,000	CU245,000
More than 90 days past due	11.0%	CU1,500,000	CU165,000
		CU34,000,000	**CU824,000**

HEDGING

HEDGING – CHANGES FROM IAS 39

Arbitrary rules - replaced with principle-based requirements

Hedge effectiveness linked to documented Risk Management Strategy and Objectives

Establish Hedge Ratio

80% / 125% effectiveness test removed

Assess within risk management objective

Prospective effectiveness test with ration rebalancing

RISK ASSESSMENT

- Gather information / data to support hedge
- Involve specialist
- Documented Risk Management Strategy and Objectives

DO YOU NEED ASSISTANCE?

MONTHLY FINANCIAL REPORTING WEBINARS

- https://www.bdo.com.au/en-au/insights/audit-assurance/webinars/2018-financial-reporting-accounting-standards

- Next month's Webinar (22 August 2018)
  - IFRS 9 – Problem Areas

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