PRACTICAL ISSUES WHEN IMPLEMENTING IFRS 9

March 2019

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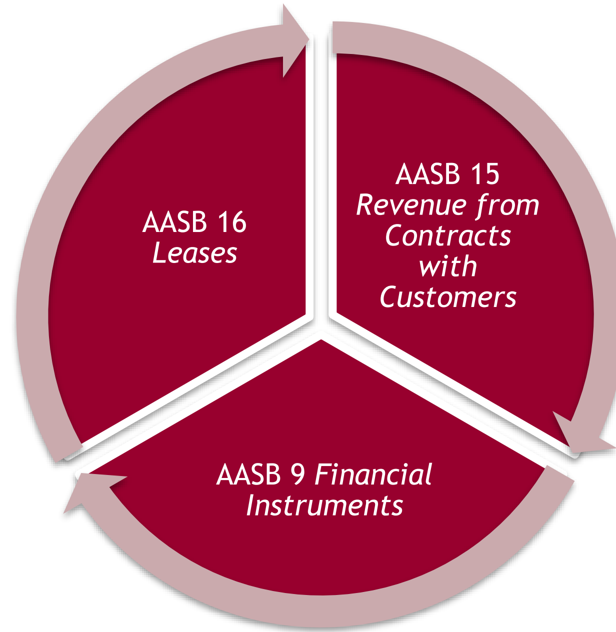
INTRODUCTION

NEW ACCOUNTING STANDARDS



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EFFECTIVE DATE

Accounting Standard	Effective Date - Years Beginning on or after …	31 December Year-ends	30 June Year-ends
IFRS 9 *Financial Instruments*	1 January 2018	31 December 2018	30 June 2019

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MOST ENTITIES WILL HAVE COMPLETED ONE YEAR UNDER IFRS 9 BY 30 JUNE 2019

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TRANSITION

30 June Year End

1 July 2017

1 July 2018

30 June 2019

Comparative period

First day of Comparative Period

Date of Initial Application

Mandatory application of IFRS 9

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ISSUES

- Identified from real-life issues encountered on ‘date of initial application’
  - Companies reporting half year and full year results (December 2018)
- Impairment
  - Trade receivables
  - Related party loans

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- 2019 Webinars dealing with IFRS 9
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  - Problem Areas (August 2018)
  - Risk Assessment (July 2018)
  - Transition (June 2018)
  - Classification and Measurement (March 2017)
  - Impairment (April 2017)
  - Hedging (December 2017)

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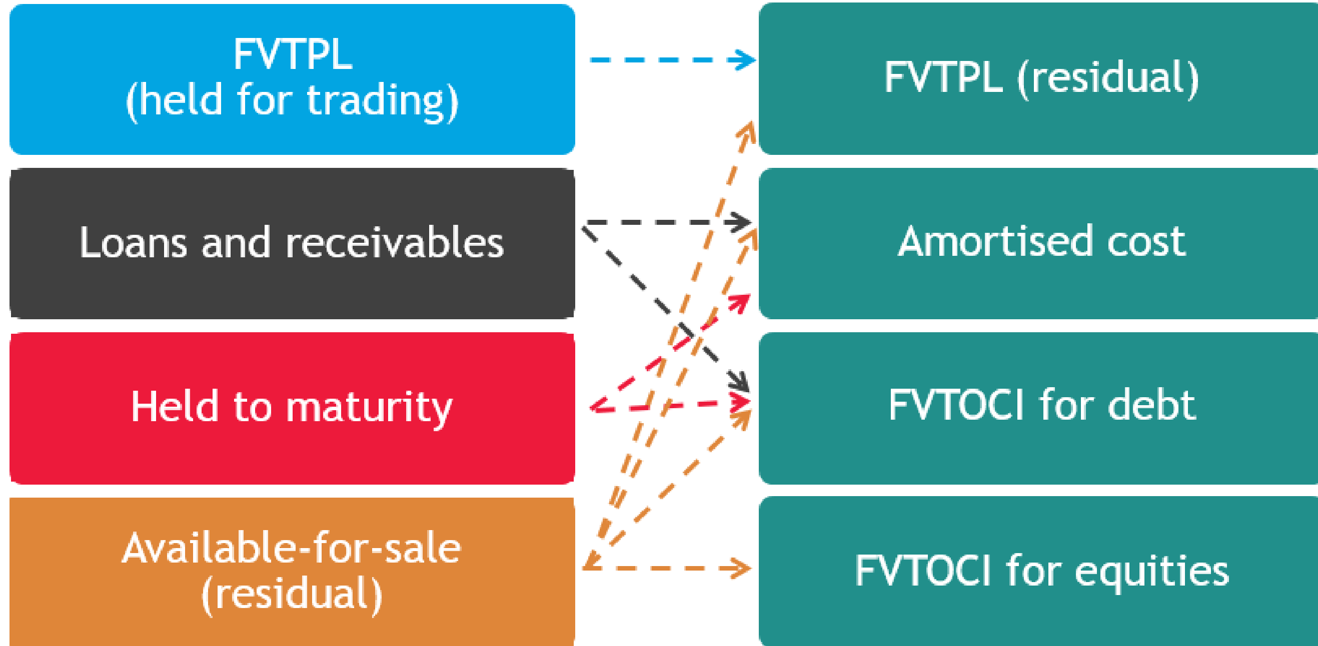
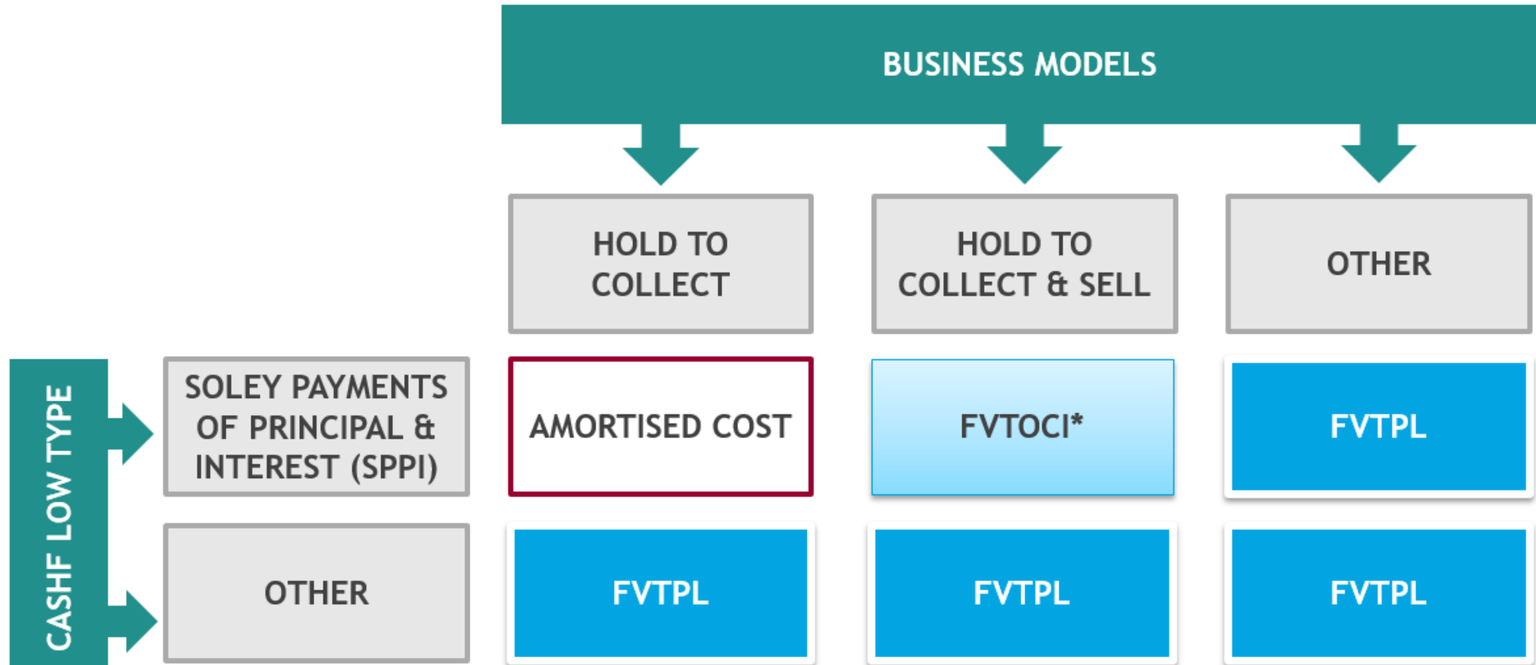
CLASSIFICATION – CHANGES FROM IAS 39



CLASSIFICATION – IFRS 9



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

IMPAIRMENT – TRADE RECEIVABLES

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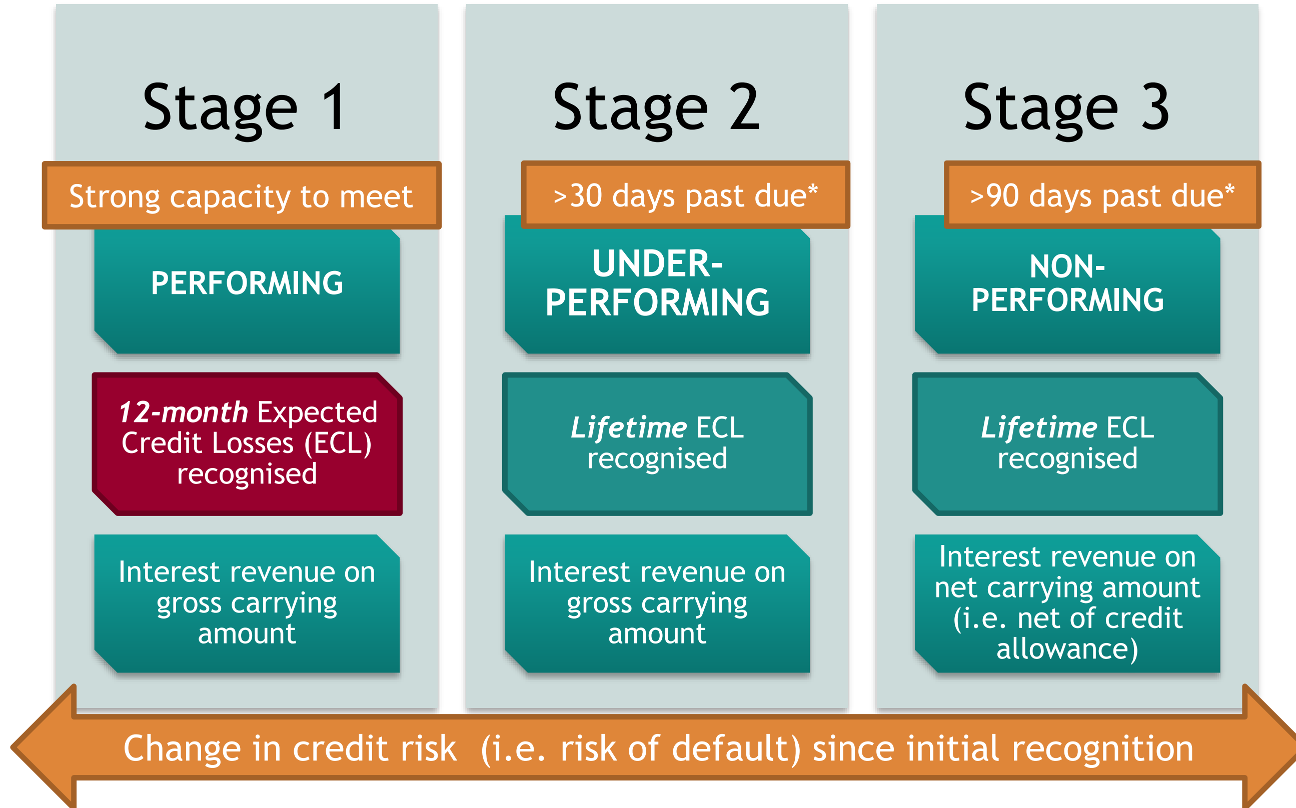
IMPAIRMENT - GENERAL APPROACH



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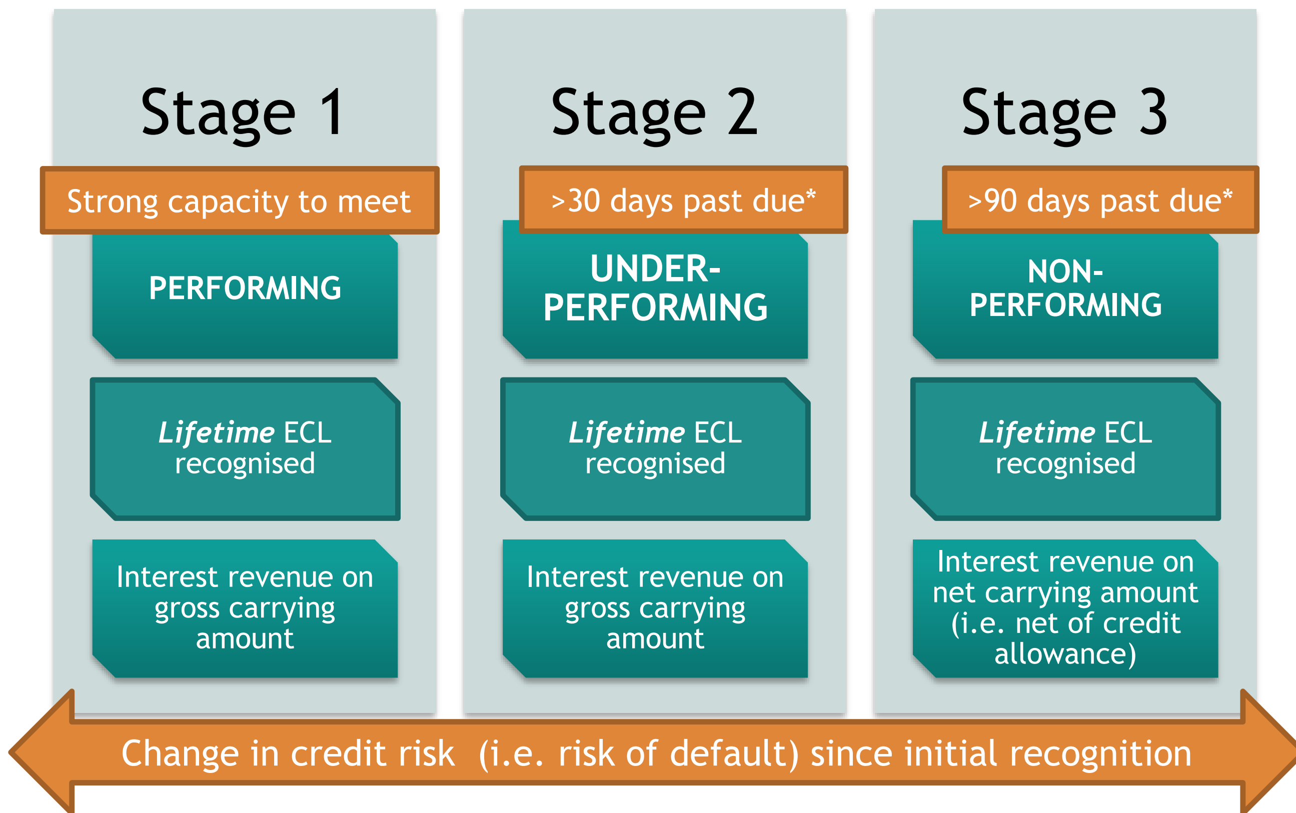
IMPAIRMENT – SIMPLIFIED APPROACH



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LIFETIME ECL

- Credit losses = difference between present value of *expected* and *contractual* cash flows
- ECL (expected credit losses) = weighted average of credit losses using *risk of default* as a weight, measured in a way that reflects:
  - Unbiased, probability-weighted amount; range of possible outcomes
  - Time value of money
  - *Reasonable and supportable information* available without *undue cost and effort* about *past events, current conditions and future economic conditions*
- Lifetime ECL = ECL that result from all possible default events over expected life of instrument

IMPAIRMENT – SIMPLIFIED APPROACH

- Apply to:
  - Trade receivables and contract asset (IFRS 15) without significant financing component (mandatory)
  - Trade receivables and contract asset (IFRS 15) with significant financing component (as policy choice)
  - Lease receivables (as policy choice)

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IMPAIRMENT – SIMPLIFIED APPROACH (PROVISION MATRIX)

Ageing	Expected loss rate (default rate) %	Receivables at 30 June 2019 $	Loss allowance at 30 June 2019 $
Not past due	**0.62%**	28,617	178
Past due 1-30	**2.77%**	9,680	268
Past due 31-61	**6.80%**	1,541	105
Past due 61-90	**30.00%**	508	152
Past due over 90	**100.00%**	1,087	1,087
		41,433	1,790

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LIFETIME ECL (PROVISION MATRIX)

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IMPAIRMENT – SIMPLIFIED APPROACH (PROVISION MATRIX)

Step	
Step 1	Identify the portfolio of receivables
	Sydney Urban (excluding Rural)
Step 2	Define Historical period or periods
	12 months ended 31 December 2018

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IMPAIRMENT – SIMPLIFIED APPROACH (PROVISION MATRIX)

Step 3 **Gather historical data for historical period and establish payment profile**

a)

Credit sales for the period	315,000
Uncollected (write off)	-750
Collected	314,250
Historical loss rate (default rate)	0.24%

b)

Collection Profile	
Not past due	195,835
Past due 1-30	92,416
Past due 31-61	15,948
Past due 61-90	10,051
Past due over 90	-
Total	314,250

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IMPAIRMENT – SIMPLIFIED APPROACH (PROVISION MATRIX)

Step 4 **Determine historical sales ageing profile**

Historical credit sales ageing profile	Collected	Total Collected	Ageing profile (=Amount outstanding)	Express historical loss rate within sales ageing profile
Not past due	195,835	195,835	119,165	0.63%
Past due 1-30	92,416	288,251	26,749	2.80%
Past due 31-61	15,948	304,199	10,801	6.94%
Past due 61-90	10,051	314,250	750	100.00%
Past due over 90	-	314,250	750	100.00%
Total	314,250			

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LIFETIME ECL (PROVISION MATRIX)

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- Lifetime ECL = ECL that result from all possible default events over expected life of instrument

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REASONABLE AND SUPPORTABLE

- *Past*, *current* and *future*
  - Adjust for effects of the *current* conditions and *forecasts* of future conditions that did not affect portfolio
    - Macro-economic
    - Extrapolation (?)
  - Remove effects of conditions that are not relevant to *future* contractual cash flows
  - Leave unadjusted depending on nature of portfolio when compared to circumstances at the reporting date
  - Make sure calculations or estimates are directionally consistent with changes in related observable data
    - Internal
    - External

REASONABLE AND SUPPORTABLE

- Must incorporate such information if reasonably available [and relevant] at reporting date
  - Exhaustive search not required, but must consider [and document] information that is available and relevant (observable)
  - Its about what information is used rather than if used - cannot use ‘undue cost or effort’ as reason NOT to look for information
  - If information is available for financial reporting, then its considered available without undue cost or effort
  - Examples:
    - Credit team identifies trends in early delinquency in a geographical area
    - Debtor payment is past due, then that fact is available for individual impairment assessment

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REASONABLE AND SUPPORTABLE

- Must consider information [and document] factors that are specific to the borrower and general economic conditions
- Must include an assessment of both the *current* as well as the *forecast* direction of conditions at the reporting date
- Examples:
  - Cash interest rate declining over historical period; forecast says 50/50 chance rates to rise in next financial year

REASONABLE AND SUPPORTABLE

- Relationship between ‘undue cost or effort’ and ‘shared credit characteristics’
  - Increased use of ‘undue cost or effort’ relief means more heavily dependent use of historical information
  - One method suggested by the standard-setter is greater use of segmentation of portfolios so losses of one group aren’t hidden by losses of another

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IMPAIRMENT – SIMPLIFIED APPROACH (PROVISION MATRIX)

Step 5 **Adjust for current and forward looking information**

Historical loss rate (default rate)	**0.24%**

Historical / comparative / forecast year	2018	2016	2019
Historical / forecast loss rate	0.24%	0.35%	0.00%
Weighting (0-100) - loss occuring	60	40	
Weighting (0-100) - loss and no loss occuring	55	30	15

	Historical loss rate within sales ageing profile	Adjusted loss rate within adjusted sales ageing profile	Expected loss rate within adjusted sales ageing profile
Not past due	0.63%	0.75%	0.62%
Past due 1-30	2.80%	3.31%	2.77%
Past due 31-61	6.94%	8.15%	6.80%
Past due 61-90	100.00%	30.00%	30.00%
Past due over 90	100.00%	100.00%	100.00%

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IMPAIRMENT – SIMPLIFIED APPROACH (PROVISION MATRIX)

Step 7 **Apply to receivables at reporting date (30 June 2019)**

Ageing	Expected loss rate (default rate) %	Receivables at 30 June 2019 $	Loss allowance at 30 June 2019 $
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- Use of portfolios
- Length of time of historical period
- Reliability of ageing
  - Using unadjusted historical loss rate (default rate)
- Information flowing from credit risk management processes
  - Individual assessment versus portfolio assessment
  - Impact on unadjusted historical information

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APPLYING IFRS 9 TO RELATED COMPANY LOANS

- IFRS 9 makes no distinction between unrelated third party and related party transactions

- Entities that prepare **stand-alone financial statements** are required to apply the full provisions of the standard to all transactions within its scope, that is:
  - Related company loan receivables must be classified and measured in accordance with the requirements of IFRS 9,
  - Where relevant, applying the Expected Credit Loss (ECL) model for impairment

- Potential challenges, because related company loans:
  - Are often advanced on terms that are **not** arms-length
  - Are sometimes advanced on an informal basis without any terms at all
  - Can contain features that expose the lender to risks that are not consistent with a basic lending arrangement

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COMMON EXAMPLES OF RELATED COMPANY LOANS

- Related company loans include:
  - Loans between a parent and a subsidiary
  - Loans between fellow subsidiaries (i.e. intragroup loans)
  - Loans to associates or joint ventures (including those long terms interests that form part of the net investment in accordance with IAS 28)

Provided related company loans are entered into on terms that are consistent with an arms-length lending transaction, applying IFRS 9 should not present any additional complexity than it would for third party loans

COMMON EXAMPLES OF RELATED COMPANY LOANS

- The following types of arrangements are relatively common:
  - Loans advanced on an interest-free basis or at a rate of interest that is not considered arms-length
  - Loans advanced on an interest-free basis that are repayable on demand but where recovery is neither planned nor expected for some years
  - Loans advanced to an entity with insufficient equity or resources to allow for its repayment or where the repayment is linked to underlying asset performance
  - Loans advanced on an undocumented basis – i.e. with no contractual terms

Applying IFRS 9 to these types of related company loan receivables can be complex and requires careful analysis

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- https://www.bdo.com.au/en-au/services/audit-assurance/ifrs-advisory-services/ifrs-technical-resources

OR

- https://www.bdo.global/getattachment/Services/Audit-Assurance/IFRS/IFRS-in-Practice/Applying-IFRS-9-to-Related-Company-Loans-2018.pdf.aspx?lang=en-GB

EXAMPLE - INTEREST FREE-TERM LOAN

- Parent A obtains external bank financing at competitive market rates and then lends to its subsidiaries on an interest-free basis
- On 1 January 2018, Parent A advanced a loan of $1 million to Subsidiary B with the following terms:
  - CU1 million repayable in three years – December 2020;
  - 0% interest
- The purpose of the loan is to fund Subsidiary B's ongoing business operations and, based on current cash flow projections, Subsidiary B is expected to be in a position to fund the repayment of the loan by December 2020. Assume that:
  - The market rate of interest for a loan with similar terms is 15%
  - The loan not considered POCI

Question: Does the loan meet the SPPI test?

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EXAMPLE - INTEREST FREE-TERM LOAN

- In order to meet the SPPI test, the contractual cash flow of CU1 million in three years must represent payments of principal (being the initial fair value) and interest (being interest accrued using the EIR method)
- The initial fair value will be the amount recognised in accordance with IFRS 9 at initial recognition that is generally equal to the transaction price
- However, in the case of long-term interest-free loans, the standard contains guidance that is more specific. In such scenarios, the initial fair value is measured as the present value of future cash receipts discounted at an appropriate market rate of interest for a similar loan at the date of initial recognition

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EXAMPLE - INTEREST FREE-TERM LOAN

- In this example, the present value of $ 1million in three years discounted by the market rate of interest of 15% is CU658,000
- This amount will accrete back to $1 million over the 3-year life of the loan using the EIR method at a rate of 15%
- In this way, the contractual cash flow of CU1 million due in 2020 represents payments of principal (being the initial fair value of CU658,000) and interest (being the accretions of CU342,000)
- The loan therefore meets the SPPI test

EXAMPLE - INTEREST FREE-TERM LOAN

- The difference between the initial fair value of $658,000 and the amount of cash advanced of $1 million (i.e. CU342,000) will be considered a capital contribution and an addition to Parent A's investment in the Subsidiary B
- This amount will not be within the scope of IFRS 9. Instead, it will be accounted for in accordance with IAS 27 and subject to impairment testing in accordance with the requirements of that standard (i.e. IAS 36 *Impairment of Assets*)

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NEWSLETTERS & OTHER PUBLICATIONS

- https://www.bdo.com.au/en-au/services/audit-assurance/accounting-resources
- https://www.bdo.com.au/en-au/services/audit-assurance/ifrs-advisory-services/ifrs-technical-resources

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