

Ind AS 109 Financial Instruments

Impairment and Derecognition

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Agenda

- ▶ Impairment: Financial instruments
 - ▶ Expected credit loss model
 - ▶ Measurement of expected credit loss model
- ▶ Derecognition of financial assets
- ▶ Derecognition of financial liabilities

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Impairment- Financial instruments



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Expected credit loss model

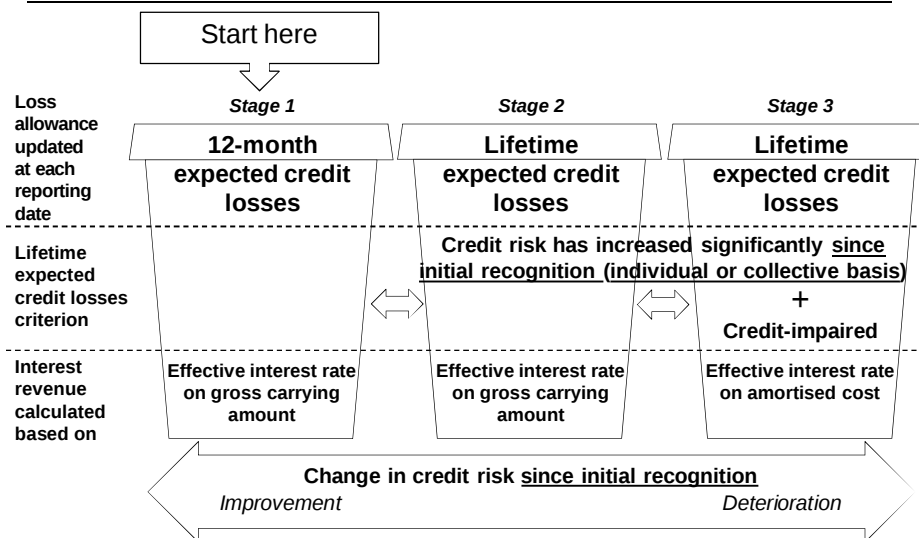


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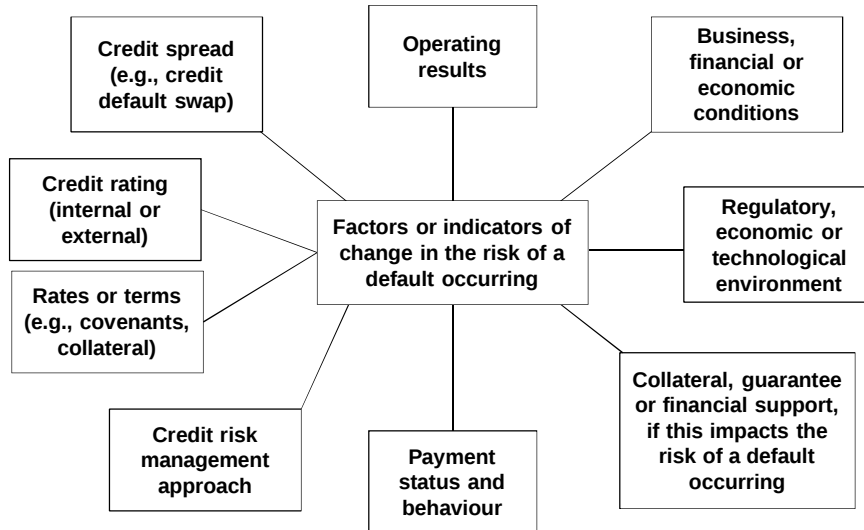
Scope and variation of the expected credit loss model

Scope of Expected credit loss requirements	General approach	Simplified approach
Ind AS 109 Financial Instruments		
Trade receivables that do not contain a significant financing component		ü
Trade receivables that contain a significant financing component	Policy election at entity level	
Other debt financial assets measured at AC or at FVOCI	ü	
Loan commitments and financial guarantee contracts not accounted for at FVPL	ü	
Ind AS 17 Leases		
Lease receivables	Policy election at entity level	

Expected credit loss model – general approach



Factors or indicators of change in the risk of a default occurring



Operational simplifications in assessing significant increases in credit risk

Low credit risk	More than 30 days past due (DPD)
For financial instruments that are equivalent to 'investment grade' quality, an entity would continue to recognise 12-month ECL	Rebuttable presumption that there is a significant increase in credit risk when contractual payments are more than 30 DPD
► An entity can assume that a financial instrument has not significantly increased in credit risk if it has low credit risk at the reporting date ► Low credit risk notion is <i>not</i> a bright-line trigger and financial instruments are <i>not</i> required to be externally rated	More than 30 DPD rebuttable presumption is intended to serve as a backstop and should identify significant increases in credit risk before default or objective evidence of impairment.

Assessment of Significant Increase in Credit Risk: Illustration

- ▶ Bank B uses an internal credit grading system of 1 to 10 with one denoting the lowest credit risk and 10 denoting the highest credit risk.
- ▶ A increase of 2 rating grades represents a significant increase in credit risk.
- ▶ It considers Grades 3 and lower to be 'low credit risk'.
- ▶ Bank B has two loans:
 - ▶ Loan 1: Graded 2 at initial recognition, Graded 5 at the reporting date.
 - ▶ Loan 2: Graded 4 at initial recognition, Graded 5 at the reporting date.

Q: At the reporting date, would each loan attract a 12-month or lifetime expected credit loss allowance?

Assessment of Significant Increase in Credit Risk: Rationale

Loan 1: Loss allowance = lifetime expected credit losses

Loan 2: Loss allowance = 12-month expected credit losses

- ▶ The credit loss model in Ind AS 109 is a relative rather than an absolute model which means that it focuses on the relative size of increase in credit risk.

Loss Allowance Recognition: Illustration

- ▶ On 31 December 20X4 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 20X4?

- 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.

Exceptions to general model

Financial assets that are credit-impaired on initial recognition

- At each reporting date, an entity shall recognise in profit or loss amount of change in lifetime expected credit losses as an impairment gain or loss

Simplified approach for trade receivables, contract assets and lease receivables

- An entity shall always measure loss allowance at an amount equal to lifetime expected credit losses

Simplified approach: Provision matrix

- According to the simplified approach, for trade receivables and contract assets that do not contain a significant financing component, an entity shall always measure loss allowance at an amount equal to lifetime expected credit losses.
- A provision matrix could be used to estimate Expected Credit Loss for these financial instruments.

Simplified approach: Provision matrix

- ▶ For example, an entity may set up the following provision matrix based on its historical observed default rates, which is adjusted for forward-looking estimates:
 - ▶ non-past due: 0.3% of carrying value
 - ▶ 30 days past due: 1.6% of carrying value
 - ▶ 31-60 days past due: 3.6% of carrying value
 - ▶ 61-90 days past due: 6.6% of carrying value
 - ▶ more than 90 days past due: 10.6% of carrying value

Credit Impaired Financial Asset

- ▶ A financial asset is credit-impaired when one or more events that have detrimental impact on estimated future cash flows of that financial asset have occurred like:
 - ▶ significant financial difficulty of issuer or borrower;
 - ▶ breach of contract, such as a default or past due event;
 - ▶ reasons relating to borrower's financial difficulty, having granted concession(s) that the lender would not otherwise consider;
 - ▶ probable that borrower will enter bankruptcy or other financial reorganisation;

Credit Impaired Financial Asset

- ▶ disappearance of an active market for that financial asset; or
- ▶ purchase or origination of financial asset at a deep discount that reflects the incurred credit losses.

- ▶ It may not be possible to identify a single discrete event—instead, combined effect of several events may have caused financial assets to become credit-impaired.

Measurement of expected credit losses



Definition of 12-month and lifetime expected credit losses

Lifetime expected credit losses

*Expected credit losses that result from **all possible default events** over the **expected life** of a financial instrument.*

12-month expected credit losses

*The **portion** of lifetime expected credit losses that result from **default events** on a financial instrument that are **possible within the 12 months** after the reporting date.*

'Default'

*Definition is **not defined** by the standard and there is a **90 days past due rebuttable presumption**.*

In practice

Although 12-month horizon may be consistent with regulatory capital requirements (e.g., Basel), the computation of expected credit losses under Ind AS 109 will differ from regulatory capital calculation.

Measurement of expected credit losses

Expected credit losses

Present value of all Cash shortfalls over the remaining life, discounted at the original effective interest rate (EIR)

Cash shortfalls- Difference between all contractual cash flows that are due to an entity in accordance with contract and all cash flows that entity expects to receive

Numerator: *cash shortfalls*

- ▶ **The period over which to estimate Expected credit Loss:** maximum contractual period
- ▶ **Probability-weighted outcomes:** possibility that a credit loss occurs, no matter how low the possibility
- ▶ **Reasonable and supportable information:** information available without undue cost or effort about the past, current and future forecasts

Denominator: *discount rate*

- ▶ **Discounting period:** from cash flows date to reporting date

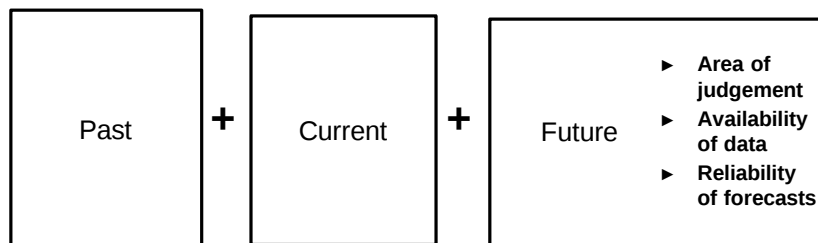
Measuring expected credit losses: implementation challenges

- ▶ Defining default
- ▶ Determining 12-month and lifetime ECL

Unbiased and probability-weighted estimate

- ▶ No prescribed approaches
- ▶ Not best estimate

Best available information



The time value of money

- ▶ Choice of discount rate

Example: Estimating expected credit losses – FVOCI (1/2)

On December 31, 2015, an entity 'Q' purchases a debt instrument with fair value of CU1,000 and classifies it as measured at FVOCI. The instrument is not credit-impaired. Q estimates 12 month expected credit losses for the instrument of CU 10. On initial recognition of the instrument, Q makes the following entries:

	Debit	Credit
Statement of Financial Position – debt securities	1000	
Statement of Financial Position – cash		1000
Profit or loss – impairment loss	10	
OCI		10

At the end of the next reporting period, the fair value of the debt instrument decreases to 950. Q concludes that there has not been a significant increase in credit risk since initial recognition and that the 12 month expected credit losses on December 31, 2016 are CU 30.

Example: Estimating expected credit losses – FVOCI (2/2)

Accordingly, Q makes the following entries at that date:

	Debit	Credit
Statement of Financial Position – debt securities		50 ^(a)
Profit or loss – impairment loss	20 ^(b)	
OCI	30 ^(c)	

Notes:

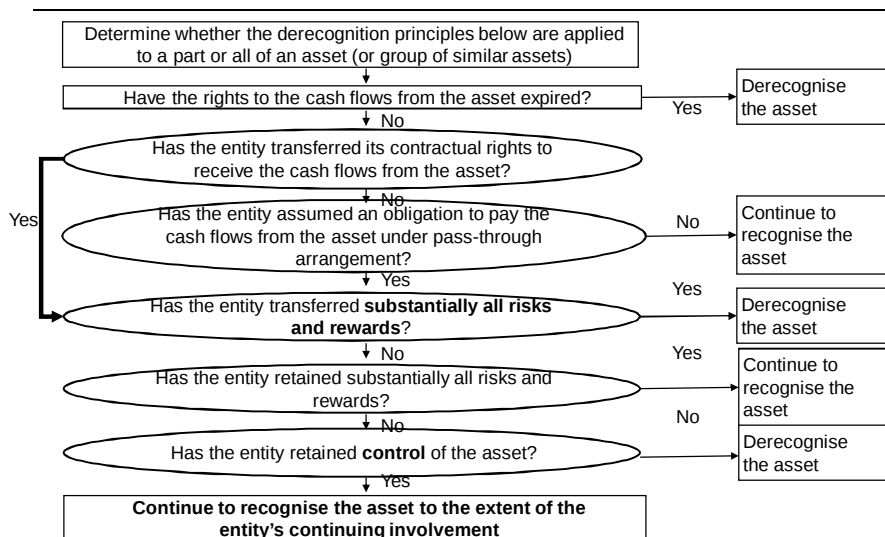
- a) Calculated as 1000-950, being the amount needed to state the debt security at fair value as at reporting date.
- b) Calculated as 30-10, being the change in expected credit losses since initial recognition.
- c) Balancing amount.

Q also provides disclosures about accumulated impairment of 30

Derecognition of Financial Assets



Derecognition of Financial Asset (1/2)



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Derecognition of Financial Asset (2/2)

When the entity's continuing involvement takes form of guaranteeing the transferred financial asset, Ind AS 39 states the extent of the entity's continuing involvement is lower of:

- ▶ Amount of the asset; and
- ▶ Maximum amount of the consideration received that the entity could be required to repay ("**guarantee amount**")

Additionally, when an entity continues to recognize an asset to extent of its continuing involvement, Ind AS 39 also requires entity to recognize an associated liability initially measured at guaranteed amount plus the fair value of the guarantee (which is normally consideration received for guarantee)

For example, Entity has loan portfolio carried at \$10 million with fair value of \$10.5 million. The entity sells the rights to 100% of cash flows to a third party for a payment of \$10.55 million, which includes a payment of \$50K in return for the transferor agreeing to absorb first \$1 million of default losses on portfolio.

Treatment under Ind AS	
Cash	10.55
Continuing involvement in assets	1.00
Loans transferred	10.00
Liability (\$1M max + \$50K guarantee)	1.05
Gain	0.50

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Derecognition of financial liabilities

Is the obligation in the contract discharged, cancelled or expired?

yes

Financial liability is extinguished

Derecognise

Modification of terms

Quantitative 10% assessment:

Does net present value of the cash flows under the new terms (including any fees paid / received), discounted using original effective interest rate, differ at least 10% from the present value of the remaining cash flows under the original terms?

yes

Substantial modification of terms

yes

Derecognise

no

Qualitative assessment:

Are there substantial differences in terms that by their nature are not captured by the quantitative assessment?

no

Continue to recognise

Accounting for an extinguishment

A gain or loss is recognised based on the difference between the carrying amount of the financial liability extinguished and the consideration paid

The consideration paid includes non-financial assets transferred and the assumption of liabilities, including the new modified financial liability

Any new financial liability recognised is measured initially at fair value

Any costs or fees incurred are recognised as part of the gain or loss on extinguishment

Accounting for a modification of terms that is not substantial

No gain or loss is recognised

Carrying amount of liability is adjusted for fees and transaction costs

Fees, transaction costs and difference in present value due to modification amortised over remaining new life of the liability

Any difference in present value arising as a result of the modification is recognised as an adjustment to effective interest rate