

Understanding the measurement of financial liabilities in accordance with IFRS 13 *Fair Value Measurement*

Date: 29 May 2023
Addis Ababa



The views expressed in this presentation are my own and not necessarily those of any organization with which I am associated.


1

Disclaimer and applicable version of IFRS Accounting Standards

- » The sponsors, the authors, the presenters and the publishers do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this PowerPoint presentation, whether such loss is caused by negligence or otherwise.
- » Unless specified otherwise, the accounting requirements that are the subject matter of this presentation are International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) that are applicable for annual period beginning on or after 1 January 2023 without early applying new and amended IFRS Accounting Standards that have a later mandatory application date.

2

2




Aim

- » The aim of this session is to enhance knowledge and understanding, in the Ethiopian accountancy market, of the fair value of financial liabilities measured in accordance with IFRS 13 *Fair Value Measurement*.
- » *[Note: the valuation session that follows after the coffee break is dedicated to enhancing skills in the Ethiopian accountancy market in the practical application of IFRS 13 to measuring the fair value of financial liabilities in the Ethiopian context.]*
- » *[Note: separate sessions on Tuesday are dedicated to enhancing knowledge and skills in measuring the fair value of financial assets in accordance with IFRS 13 in the Ethiopian context]*

3

3



Identifying financial liabilities

4

Definition of a financial instrument paragraph 11 of IAS 32 *Financial Instruments: Presentation*

Classification	Nature
Financial instrument	A financial instrument is “any contract that gives rise to a <u>financial asset</u> of one entity and a <u>financial liability</u> or <u>equity instrument</u> of another entity”
Financial liability	<ul style="list-style-type: none"> • a <u>contractual</u> obligation to deliver cash or another financial asset; • a contractual obligation to <u>exchange</u> financial assets or financial liabilities under conditions that are potentially unfavourable; or • a contract that will or may be settled in the entity’s own equity instruments and is not settled ‘fixed-for-fixed’.

5

5

Definition of a financial instrument paragraph 11 of IAS 32 *Financial Instruments: Presentation*

Classification	Nature
Equity instrument	An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
Financial asset	<ul style="list-style-type: none"> • cash; • equity of another entity; • a contractual right to receive cash or another <u>financial asset</u> • a contractual right to exchange financial assets or financial liabilities under conditions that are <u>potentially favourable</u>; or • a contract that will or may be settled in the entity’s own equity instruments and is <u>not</u> settled ‘fixed-for-fixed’.

6

6

Definition of a financial liability and scope of IFRS 9

Summary of class discussion

Is each item below a financial liability in the scope of IFRS 9?

Choose one of: 1) Yes; 2) No; or 3) it depends.

- A. Reporting Entity's obligation to repay a bank loan **1) Yes**
- B. Reporting Entity's possible obligation (ie subject to legal proceedings) to settle Payment Protection Insurance (PPI) mis-selling claims **2) No**
- C. Reporting Entity's statutory obligation to pay ETB10 billion income tax **2) No**
- D. Reporting Entity's contractual obligation to pay specified bonuses to its employees **2) No**
- E. Reporting Entity's contractual obligation to settle share appreciation rights issued to its employees. **2) No**

8

8

Loan commitments (1 of 3 slides)

Summary of class discussion

Are the following commitments in the scope of IFRS 9?

For each commitment below choose one of: 1) Yes; 2) Partial exclusion; ie the exclusion does not extend to IFRS 9's impairment requirements; or 3) No.

- A. Retailer's commitment to extend credit under a store account. **3) No (not a financial instrument because good/service to be delivered)**
- B. Manufacturer's commitment to lend to its associate at below-market interest rates. **1) Yes**
- C. Manufacturer's commitment to lend to its associate at market interest rates. **2) Partial exclusion, ie the exclusion does not extend to IFRS 9's impairment requirements.**

10

10

Loan commitments (2 of 3 slides)

Summary of class discussion

- » By way of **exception**, loan commitments are **excluded from IFRS 9** **except** if the commitment:
 - » is on initial recognition **designated** at fair value through profit or loss (**FVPL**).
 - » **can be settled net in cash** (ie a derivative) or the lender has a practice of selling its loan commitment assets of that class shortly after origination (ie treated as derivatives, **measure at FVPL**).
 - » is to **provide at below-market interest rates** (if not FVPL, then measure **initially** at FV and **subsequently** at the higher of: (i) the IFRS 9 loss allowance; and (ii) the amount initially recognised less the cumulative amount of income recognised with IFRS 15 *Revenue from Contracts with Customers*).

Source: paragraphs 2.1(g), 2.3, 4.2.1(d) and 5.5.6 of IFRS 9 and BC22.2 to BC2.8 of Basis for Conclusions on IFRS 9 11

11

Loan commitments (3 of 3 slides)

Summary of class discussion

- » **However**, an issuer of a loan commitment must apply the **impairment requirements of IFRS 9** even when the loan commitment is not otherwise in the scope of IFRS 9. For this purpose, the date of the irrevocable commitment is considered to be the date of initial recognition.
- » **Nonetheless**, **hedge accounting** applies to loan commitments that are hedged items.

Source: paragraphs 2.1(g), 2.3, 4.2.1(d) and 5.5.6 of IFRS 9 and BC22.2 to BC2.8 of Basis for Conclusions on IFRS 9 12

12

IFRS 9 financial guarantee contracts scope exclusions

- » A financial guarantee contract (FGC) **obliges the issuer** to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
- » The accounting treatment of a FGC **does not depend on its legal form**
 - » examples of legal forms of FGCs include: a guarantee; some types of letter of credit, a credit default contract or an insurance contract
- » **Credit related guarantees that are neither FGCs nor insurance contracts are derivatives** accounted for in accordance with IFRS 9
 - » For example, a credit-related guarantee that does not, as a precondition for payment, require that the holder be exposed to, and has incurred a loss on, the failure of a debtor to make payments on the guaranteed asset when due (more specifically, for example, a guarantee that requires payment in response to a change in a specified credit rating)

Source: paragraphs 2.1(e), 4.2.1(c), 5.5.6, Appendix A (definition of a financial guarantee contract), B2.5 and B2.6 of IFRS 9 and paragraphs BC22.9 to BC2.17 of Basis for Conclusions on IFRS 9

13

13

IFRS 9 financial guarantee contract (FGC) scope exclusions (continued)

- » Issuer's rights and obligations **under insurance contracts** that **satisfy the definition of a FGC** are accounted for in accordance with IFRS 9 unless the issuer:
 - » **previously asserted** explicitly that it regards such contracts as insurance contracts and accounted for such contracts as insurance contracts; and
 - » **elects** to apply **IFRS 17 Insurance Contracts to such a contract**. (Note: irrevocable election may be made contract-by-contract.)
- » If **IFRS 9** is applied:
 - » on **initial recognition measure at FV** (FV likely to equal proceeds received).
 - » thereafter, **if not** designated FVPL, measure its obligation at the **higher of**:
 - i. the **IFRS 9 loss allowance**; and
 - ii. the amount initially recognised less the cumulative amount of income recognised with *IFRS 15 Revenue From Contracts with Customers*)

Source: paragraphs 2.1(e), 4.2.1(c), 5.5.6, Appendix A (definition of a financial guarantee contract), B2.5 and B2.6 of IFRS 9 and paragraphs BC22.9 to BC2.17 of Basis for Conclusions on IFRS 9

14

14



Offsetting FRC (UK) regulatory observation

- » A financial asset and a financial liability should be **offset** when, and only when, the entity has a legal right to offset and the entity intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. (paragraph 42(b) of IAS 32)
- » In March 2016, in relation to a specifically described **cash-pooling arrangement**, the IFRS Interpretations Committee concluded that the settlement of the entire period-end balance on a net basis is necessary to meet the requirement.
- » In several cases, **bank overdrafts** or similar liabilities had been **offset against cash and cash equivalents** in the statement of financial position **but it was not clear how the IAS 32 criteria for offset were met.** (p18)

Source: FRC (UK), Annual Review of Corporate Reporting 2020/21

15

15



Ethiopian context

16

Ethiopian context

Which financial liabilities do Ethiopian companies have?

Summary of class discussion

- » Customer deposits (e.g. banks)
- » Bank loans
- » Related party loans
- » Loan commitments
- » Financial guarantees
- » Trade payables
- » Derivatives (foreign currency?)

18

18

Ethiopian context

Example 1 Commercial Bank of Ethiopia: Extract from Consolidated Statement of Financial Position as at 30 June 2021 (Birr)

Liabilities			
Deposits due to other banks		364,945,567	1,109,055,430
Customers' deposits	21	735,295,983,493	593,041,145,062
Current tax liabilities	25	6,337,242,247	5,954,265,633
Provisions	22	1,528,010,488	1,389,959,157
Finance lease obligations	20	394,843,317	249,694,124
Dividends	24	9,571,909,473	7,771,189,170
Employee benefits	23	6,459,952,329	6,614,840,691
Other liabilities	24	177,539,624,174	153,326,630,375
Total Liabilities		937,492,511,088	769,456,779,642

19

19

Ethiopian context

Example 1 Commercial Bank of Ethiopia: Extract from Note 21 to the Consolidated Financial Statements 30 June 2021

[21] CUSTOMERS' DEPOSITS

Customers' deposits as of the reporting dates are as follows:

	30 June 2021	30 June 2020
Payable on demand		
Local and central government	93,243,166,480	75,916,850,629
Private sector and retail customers	97,547,005,613	83,054,840,010
Public enterprises and agencies	81,401,958,139	84,226,683,568
	272,192,130,231	243,198,374,207
Savings deposits		
Private sector and retail customers	381,172,820,000	284,316,050,920
Public enterprises and agencies	21,055,928,877	18,164,981,220
	402,228,748,876	302,481,032,140
Term deposits		
Public enterprises and agencies	3,569,973,166	5,344,429,376
Private sector and retail customers	2,098,692,714	2,854,599,953
Local and central government	3,000,000,000	6,300,000,000
Accrued interest on deposits	167,327,801	
	8,835,993,681	14,499,029,329
Blocked accounts	-	346,110,967
CBE NOOR	52,039,110,704	32,516,598,419
All sectors	735,295,983,493	593,041,145,062

Payable on demand accounts represents deposits that are non-interest bearing. The weighted average effective interest rate on **Savings deposits** as at 30 June 2021 was 7% (2020: 7%). The weighted average effective interest rate on **Term deposits** as at 30 June 2021 was 7.2% (2020: 7.2%). **Blocked accounts** represent blocked current accounts and blocked savings accounts whose average effective interest rates as at 30 June 2021 were 0% and 7% respectively (2020: 0% and 7% respectively). **CBE NOOR** represents deposits that are non-interest bearing.

20

20

Ethiopian context:

Example 2 Ethiopian Airlines Group: Extract from Consolidated Statement of Financial Position as of 30 June 2021 (Birr)

NON-CURRENT LIABILITIES			
Long term loans	2(k),20	110,519,999,739	89,472,803,316
Provision for maintenance	2(n),21	1,989,705,448	1,377,127,013
Lease liabilities	2(c),29B	109,222,026,756	92,127,102,064
Employee benefit	22	645,728,071	477,942,719
Deferred Tax Liability	23	6,675,617	0
Deferred and non-current liabilities	24	1,957,386,925	1,200,227,818
		224,341,522,556	184,655,202,930
CURRENT LIABILITIES			
Trade and other liabilities	2(j),25	20,809,826,985	16,403,349,810
Contract Liabilities	30	30,837,997,233	21,047,015,322
Profit Tax Payable	26	8,607,070	0
State dividend payable current portion		0	110,131,034
Current maturity of lease Liabilities	2(c),29B	16,336,369,843	12,373,480,965
Current maturity of long term loans	20	18,925,273,886	15,451,812,026
		86,918,075,019	65,385,789,157
TOTAL EQUITY AND LIABILITIES		470,086,186,042	369,965,880,872

21

21

Ethiopian context: Example 2 Ethiopian Airlines Group: Extract from Note 20 Long term loans to the Financial Statements 30 June 2021

	Birr	2020 Birr
Balance at 30 June 2020	103,907,856,767	89,241,763,899
Additional loans	17,141,346,321	13,787,226,725
Currency Translation Difference	<u>26,562,883,888</u>	<u>18,628,841,738</u>
Less: Repayments	147,612,086,976	121,657,832,361
	<u>18,166,813,349</u>	<u>16,733,217,019</u>
	129,445,273,627	104,924,615,343
Less: Amounts repayable within 12 months	<u>18,925,273,886</u>	<u>15,451,812,026</u>
	<u>110,519,999,739</u>	<u>89,472,803,316</u>

Loans from foreign lending institutions, secured on aircraft, bearing interest at rates of between 1.50% and 7.31% per annum, and repayable in quarterly instalments.

Secured and unsecured loans from local and foreign lending institutions and development agencies, bearing interest at rates of between 2.38% and 4.66% per annum, and repayable in, mainly, quarterly instalments.

22

22



IFRS 9 financial liability measurement models

23

When are financial liabilities measured at fair value? Summary of class discussion

At initial recognition	Subsequent measurement	Disclosure only
<p>Nearly all financial liabilities in the scope of IFRS 9.</p> <p>Exceptions include paragraph 63 of IFRS 15 <i>Revenue from Contracts with Customers</i>.</p> <p>However, include transactions costs in initial measurement of liability, except when subsequent measurement model is FVPL.</p>	<p>Financial liabilities typically using amortised cost model.</p> <p>Exceptions:</p> <ul style="list-style-type: none"> Classified FVPL (derivatives) Designated FVPL. Contingent consideration in a business combination (FVPL). Financial guarantee contracts and below market loan commitments (typically > ECL or recognition-date FV less IFRS 15 run off). 	<p>IFRS 9 when carrying amount is not a reasonable approximation of fair value.</p>

25

25

Financial instruments measurement at initial recognition Summary of class discussion

- » **Principle:** initially measure a financial asset at its **fair value (FV)**.
- » However, IFRS 9 specifies exceptions from principle. For example:
 - » **Rule:** when in accordance with IFRS 15 *Revenue from Contracts with Customers* trade receivables are measured initially at their transactions price which differs from FV, (for example, when the practical expedient in paragraph 63 of IFRS 15 applies).
 - » **Rule:** when FV on initial recognition does not equal transaction price and FV is not Level 1 or 'upper' Level 2 (ie only observable inputs), then defer recognition of 'day-1 gain'.
- » **Principle:** when subsequent measurement = FVPL, **transactions costs** are an expense.
 - » **Rule:** if not subsequently measured at FVPL add/(deduct) transactions costs to/(from) a financial asset's/(financial liability's) initial FV.

Sources: paragraph 5.1.1 of IFRS 9 and paragraph 43 of IAS 39

26

26

Fair value of a financial liability

Summary of class discussion

» On 31/12/2022:

- » Reporting Entity receives ETB10 billion proceeds of a 1-year term interest free loan from a related party.
- » Had Reporting Entity been obliged to pay the market interest rate, on its promise to pay ETB10 billion on 31/12/2023, it would have received only ETB8 billion on 31/12/2022.

» **At 31/12/2022 the fair value of Reporting Entity's financial liability is?** Choose one of: **1) ETB8 billion;** 2) ETB10 billion; or 3) another amount (specify...).

28

28

Fair value of interest-free loans

mini-case study: a regulators ruling: JSE (South Africa) (emphasis added)

Matter 21 (2011): In determining the fair value for initial recognition purposes of a financial asset or liability **issuers cannot simply assume that the transaction price is the fair value.**

Matter 13 (2014): The application of IFRS to interest free loans continues to be misunderstood. These loans must be measured at fair value plus transaction costs on initial recognition. The **contract value of the loan is not the fair value.** In one instance, the misapplication of this principle extended to a loan with a fixed interest rate.

Matter 11 (2015): The application of IFRS to interest free loans continues to be misapplied. The **contract value of such a loan is not its fair value.**

Source: Combined findings of the JSE proactive monitoring of financial statements, 28 October 2022, p59 ²⁹

29

Financial liability measurement subsequent measurement *Summary of class discussion*

Measurement models

Amortised cost (using the effective interest method)

- most financial liabilities (exceptions apply, for examples of the exceptions see below)

Fair value, for example:

- IFRS 9 (paragraph 4.2.1): held for trading (including most derivatives);
- contingent consideration recognised by an acquirer in a business combination.

Other specified measurements for particular financial liabilities in specified circumstances (for examples see paragraph 4.2.1 of IFRS 9). For example, typically, financial guarantees and commitments to provide a loan at a below-market interest rate.

30

30

Financial liabilities selected judgements and estimates

Financial liability: IFRS 9

Classification:

- determining whether **conditions for classifying as FVPL** are satisfied
- determining whether the underlying in some **contracts to buy or to sell a non-financial item** are **readily convertible into cash** and therefore in the scope of IFRS 9

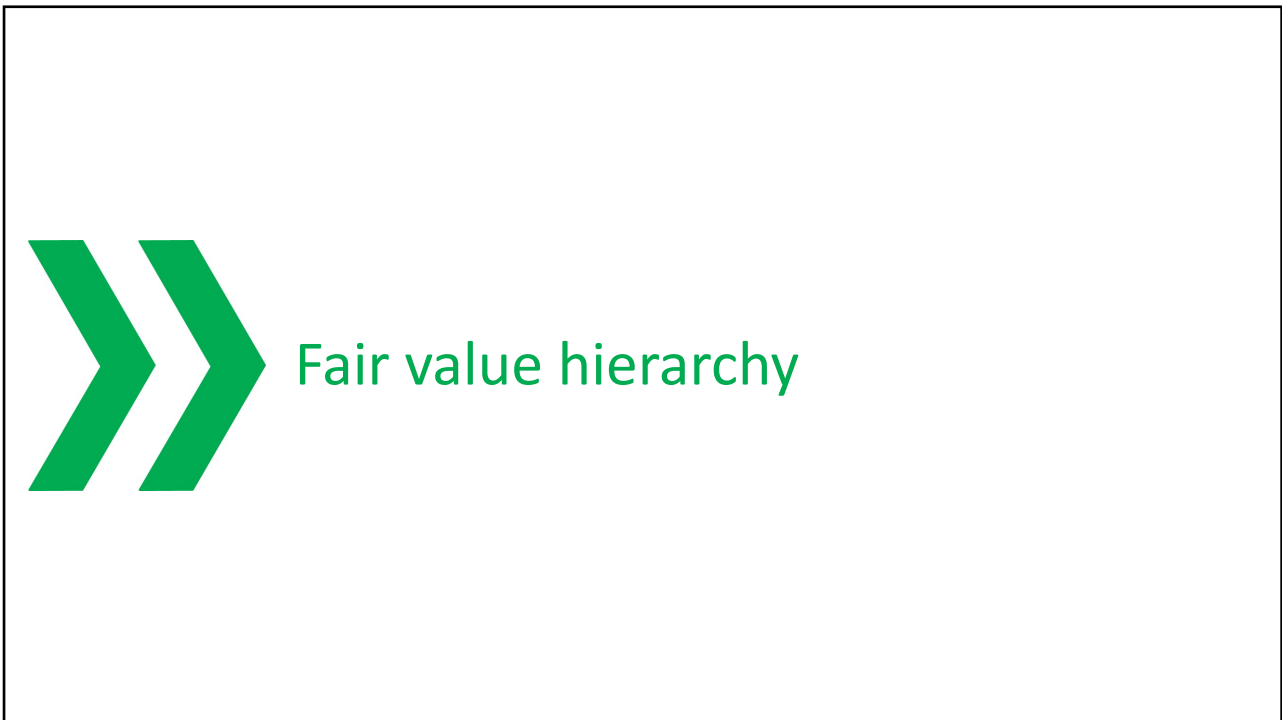
Measurement:

- **measuring the fair value** of some liabilities (for example, derivatives whose measurement includes Level 3 inputs)

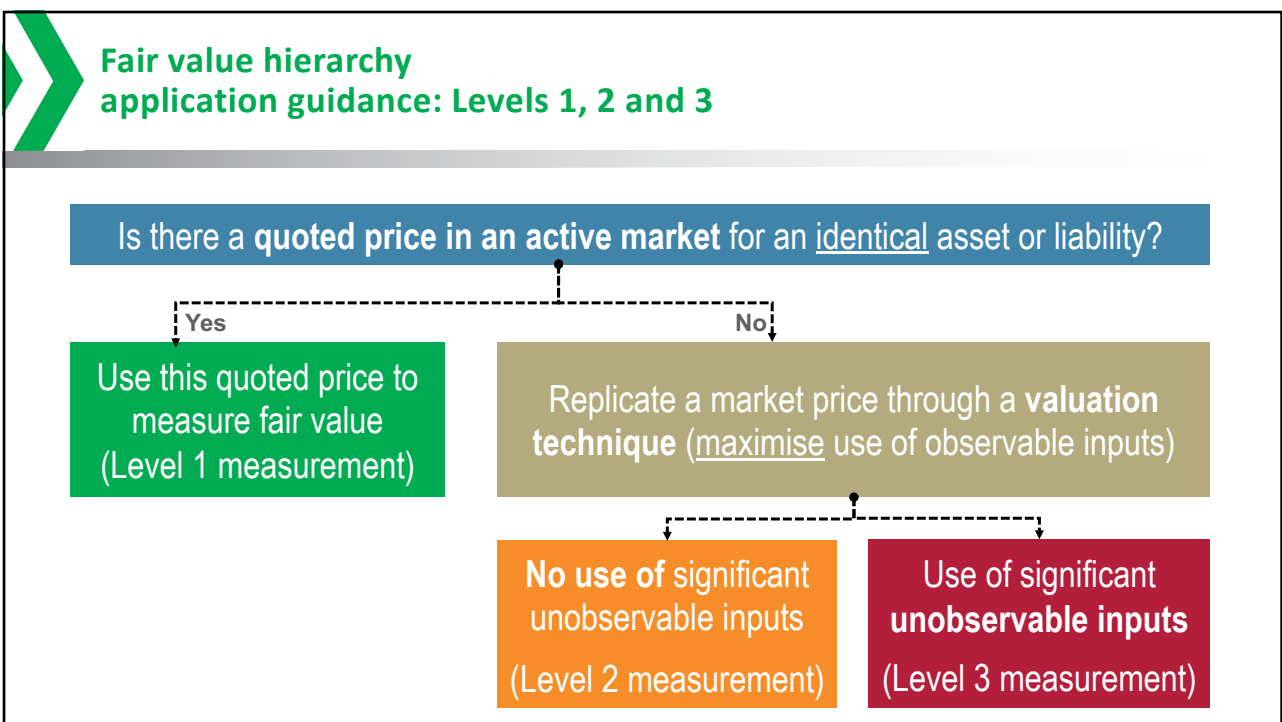
Presentation:

- estimating the amount of the change in the fair value of a financial liability that is **attributable to a change in its own credit risk**.

31



32



33



Fair value hierarchy classification of corporate debt

Summary of class discussion

Reporting Entity's debt is listed in the Nairobi Stock Exchange.

At which level of the FVM hierarchy is the exchange listed liability likely categorised? Choose one of: 1) Level 1; 2) Level 2; 3) Level 3; or 4) it depends....

35

35



Fair value of JSE listed debt instruments

mini-case study 1: background information (emphasis added)

- » The interest rate valuation team of the Johannesburg Securities Exchange (JSE) issued a report in 2014 titled "Debt Market, Mark to market valuation rules". That report highlighted:
 - » the majority of listed debt instruments (especially corporate) **rarely trade**, and pre and post trade information is infrequent; and
 - » there is currently **no real centralized price discovery venue for corporate debt**.

36

36

Fair value of JSE listed debt instruments mini-case study 1: a regulators ruling: JSE (South Africa) (emphasis added)

- » In its compliance review of 2016 financial statements, JSE proactive monitoring found that in nearly all instances, debt Issuers, in applying IFRS 13, **inappropriately classified their own debt instruments as being within the Level 1** hierarchy because the market in which the quoted price is observed is not an 'active market' given the **inactivity** of trade in listed notes on the South African interest rate market.
 - » Even when trade does occur, it is **not usually of sufficient frequency and volume** to meet a Level 1 classification. At best, corporate debt in South Africa is likely to be a Level 2 classification, and perhaps even a Level 3.
- » Similarly, JSE concluded that a special purposes vehicle that issued mortgage bond securities had **incorrectly classified their debt instruments as a Level 1** fair value.

Source: REPORTING BACK ON PROACTIVE MONITORING OF FINANCIAL STATEMENTS IN 2016

37

37

Fair value hierarchy classification of trade payables *Summary of class discussion*

At which level of the FVM hierarchy Ethiopian trade payables liabilities likely categorised? Choose one of: 1) Level 1; 2) Level 2; or 3) Level 3.

39

39

Fair value of financial instruments mini-case study 2: a regulators ruling: JSE (South Africa) (emphasis added)

» In its proactive monitoring of 2016 financial statements the JSE observed an issuer **incorrectly classified their operational financial instruments** such as trade payables, finance leases, loans payable as being level 2 fair values as opposed to level 3 fair values.

- » As a result of this incorrect classification the level 3 disclosures were also omitted.

Source: REPORTING BACK ON PROACTIVE MONITORING OF FINANCIAL STATEMENTS IN 2016

40

40

Examples—fair value measurement hierarchy judging the boundaries of the artificial constructs

Boundary between **levels 1 & 2**—do transactions in the market in which the **identical item** trades (and that the entity can access at the measurement date) take place with **sufficient frequency and volume** to provide pricing information on an ongoing basis? (IFRS 13.A)

Example **regulatory finding (emphasis added)**—JSE proactive monitoring found that in nearly all instances, **Debt Issuers**, in applying IFRS 13, **inappropriately classified their own debt instruments as being within the Level 1 hierarchy** because the market in which the quoted price is observed is **not an 'active market' given the inactivity of trade in listed notes on the South African interest rate market.**

- Even when trade does occur, it is **not usually of sufficient frequency and volume to meet a Level 1 classification.** At best, corporate debt in South Africa is likely to be a Level 2 classification, and perhaps even a Level 3.

Source: REPORTING BACK ON PROACTIVE MONITORING OF FINANCIAL STATEMENTS IN 2016

41

41



Examples—fair value measurement hierarchy judging the boundaries of the artificial constructs

Boundary between **level 2 and level 3**—**significant unobservable inputs**.

Example **entity-specific policy**—HSBC (2020) financial statements, p292:

- » “significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument’s inception profit or greater than 5% of the instrument’s valuation is driven by unobservable inputs
- » ‘Unobservable’ in this context means that there is little or no current market data available from which to determine the price at which an arm’s length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used)”

42

42



Measuring the fair value of financial liabilities

43

Measuring the fair value of financial liabilities

- » The fair value of a financial liability (IFRS 13) is:
 - » **the price** that would be paid **to transfer** a liability (exit price)
 - » in an **orderly transaction** (not a forced sale)
 - » between market participants (**market-based view**)
 - » at the measurement date (**current price**).
- » However, a **few rules**. For example:
 - » unit of account in IFRS 9 is the individual financial instrument
 - » 'Level 1' fair value = price x quantity (no adjustments).
- » **Market participant perspective**: consequently, the entity's intention to settle or otherwise fulfil a financial liability is not relevant when measuring fair value.

44

44

FVM financial liabilities measurement objective

- » **Objective: estimate** the price at which an orderly transaction to transfer a liability would take place between market participants at the measurement date under current market conditions (paragraph B2 of IFRS 13)
 - » **exit price**: assume liability will remain outstanding and the market participant transferee will fulfil the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.
- » To meet the objective must **maximise the use of relevant observable inputs** and minimise the use of unobservable inputs (paragraph 36)
 - » even when there is no observable market to provide pricing information about the transfer of a liability, there **might be an observable market for such items held by other parties as assets** (paragraph 35)

45

45

FVM financial liabilities factors and risks that affect fair value of liabilities

» Factors and risks that affect the fair value of financial liabilities include:

- » the time value of money;
- » non-performance risk (ie 'own credit risk'); and
- » liquidity risk.

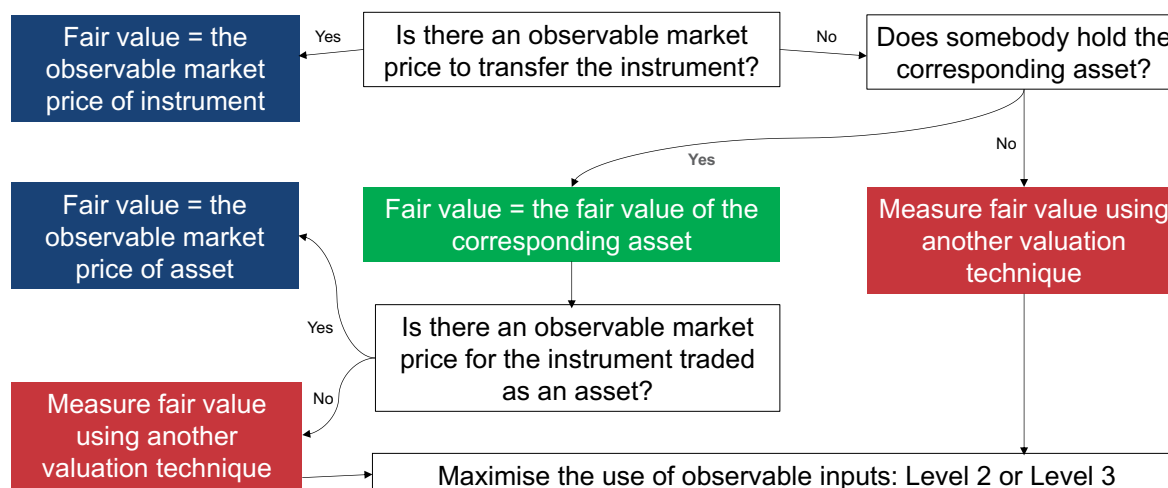
» Effect of risk:

- » variable expectations of future cash flows; and
- » price for bearing this uncertainty (paragraphs B15-B17 of IFRS 13).

46

46

Fair value: liability decision tree application guidance: liabilities



47

47

FVM issues specific to financial liabilities why FVM liability with reference to the corresponding asset?

- » The fair value of a liability **equals** the fair value of a properly defined corresponding asset (that is, an asset whose features **mirror** those of the liability), assuming an exit from both positions in the same market (paragraph BC88 of the Basis for Conclusions on IFRS 13)
 - » fair value from the viewpoint of investors and issuers should be the same given that both parties are measuring the same instrument with identical contractual terms **in the same market**.

48

48

FVM issues specific to financial liabilities exception from the Level 1 P x Q rule: corresponding asset

- » Consistently with the FVM objective, an **adjustment** **MUST** be made from the Level 1 input (asset price) when:
 - » measuring the fair value of a liability (or an entity's own equity instrument) using the quoted price for the identical item traded as an asset in an active market when that price needs to be adjusted for **factors specific to the asset**. (see paragraph 79(c) of IFRS 13)
 - » **For example, a 3rd-party credit enhancement** reflects in the FV of the asset but is accounted for separately from the liability by the issuer.

Note: the resulting measurement of the liability is not Level 1 (ie it is at Level 2 or Level 3).

49

49

FVM issues specific to financial liabilities corresponding asset in active market Summary of class discussion

- » On 30/12/2022 Reporting Entity incurs transaction costs of ETB10 billion in issuing 1 million ETB1 million debentures at their face value.
- » The debentures trade as an asset in an active market. There are no 3rd party credit enhancements or other factors that cause dissymmetry between the fair value of the asset and the fair value of the liability.
- » At 31/12/2022 the debenture assets close trading at ETB1 million per debenture.
- » **At 31/12/2022 the fair value of Reporting Entity's debenture liability is?** Choose one of: 1) ETB1,010 billion; **2) ETB1,000 billion;** or 3) ETB990 billion.
- At which level of the FVM hierarchy is the debenture liability?** Choose one of: **1) Level 1;** 2) Level 2; 3) Level 3; or 4) it depends....

51

51

FVM issues specific to financial liabilities 3rd-party credit enhancement Summary of class discussion

- The facts are the same as in the previous example, **except**
- » an independent 3rd-party of higher credit quality guarantees the debenture cash flows against credit losses (Reporting Entity accounts separately for the guarantee).
 - » At 31/12/2022 the debenture assets close trading at ETB1.05 million per debenture.
- At 31/12/2022 the fair value of the debenture liability is?** Choose one of:
- 1) ETB50 billion (fair value of the 3rd-party credit enhancement)
 - 2) **ETB1,000 billion (adjusted P of the asset x Quantity)**
 - 3) ETB1,050 billion (unadjusted P of the identical asset x Q)
- At which level of the FVM hierarchy is the debenture liability?** Choose one of: 1) Level 1; 2) Level 2; 3) Level 3; or **4) it depends (but cannot be level 1)**

53

53

FVM: financial liabilities assumed in a business combination long-term debt

- » On 31/12/2017 (acquisition-date), in a business combination, Reporting Entity assumes two types of long-term debt. Both liabilities were originated by the Acquiree on 01/01/2017 in exchange for ETB1,000 billion each.
- » Trades as an asset in an active market: 1 billion **debentures** with face value of ETB1,000 each; 10% fixed-rate interest; mandatorily redeemable on 31/12/2022.
 - » On 31/12/2017 (after paying accrued interest) Acquiree debentures traded actively at ETB950 billion before business combination and ETB975 billion after it. (The ETB25 billion difference is attributed to market participant' assumptions about credit enhancements resulting from the business combination).
- » **Bank loan:** ETB1,000 billion is mandatorily repayable on 31/12/2022; 12% fixed-rate interest.

54

54

FVM: financial liabilities assumed in a business combination long-term debt What do you think?

- » Management has determined that both liabilities assumed in the business combination must:
 - » **initially** be measured at fair value (in accordance with IFRS 3 *Business Combinations*)
 - » **subsequently** be measured at amortised cost (in accordance with IFRS 9)
- Q1: At what amount must Reporting Entity initially measure the fair value of the debenture liability assumed in the business combination?**
Choose one of: 1) ETB950 billion; 2) ETB975 billion ; or ETB1,000 billion.
- Q2: How should Reporting Entity measure the fair value of the Bank loan liability assumed in the business combination? Discuss...**

55

55

FVM: financial liabilities assumed in a business combination

long-term debt

Summary of class discussion

Q1: At what amount must Reporting Entity initially measure the fair value of the debenture liability assumed in the business combination?

Choose one of: 1) ETB950 billion; 2) ETB975 billion; or ETB1,000 billion.

Q2: How should Reporting Entity measure the fair value of the Bank loan liability assumed in the business combination? The market value of the traded debt is a Level 1 input to adjust from to measure the fair value of the bank loan liability. To do so, from the market participant perspective:

- » Understand similarities and differences between the contractual terms of the two instruments. For example, why the untraded debt is paying 2% higher than the traded debt (Is there something other than relative liquidity? For example, relative quality of collateral, if any).
- » Also understand if the business combination impacts the two liabilities differently. For example, does it infer different credit enhancements.

56

56

FVM issues specific to financial liabilities

examples of valuation techniques for financial guarantees

Examples of techniques used to measure the fair value of **financial guarantees** include:

- » Adjusted market prices of comparable instruments
 - » use when can identify market prices for similar guarantees, credit default swaps, or credit insurance products.
- » Probability weighted discounted cash flow analysis
 - » use when can identify entities with the same credit rating as the reporting entity but consider whether historical default rates should be updated to reflect current and forecasted economic conditions.
- » Interest rate differentials
 - » use at inception of the guarantee when the difference between the interest charged on the guaranteed loan and what would have been charged had the loan not been guaranteed is reliably determinable.

57

57

FVM issues specific to financial liabilities

financial guarantees

Summary of class discussion

- » On 31/12/2023 Bank advances ETB100 billion loan to Associate. On 31/12/2026 the loan must be extinguished by Associating paying Bank ETB131 billion.
- » Reporting Entity holds a 40% equity interest in Associate. If on 31/12/2026 Associates defaults, Reporting Entity must pay Bank ETB131 billion (ie Reporting Entity's guarantee).
- » Had Reporting Entity not guaranteed the loan to Associate, the terminal contractual cash flow Bank would have charged = ETB195.3125 billion (ie the EIR would have been 25%).

At 31/12/2023 the fair value of Reporting Entity's guarantee liability is? Choose one of:

- 1) ETB95.3125 billion (ie ETB195.3125 billion less ETB100 billion)
- 2) ETB64.3125 (ie ETB195.3125 billion less ETB131 billion)
- 3) ETB0 [ie (ETB195.3125 billion/(1.25)³ less ETB100 billion]
- 4) **ETB32.928 billion [ie (ETB131 billion/(1.25)³ less ETB100 billion]**

59

59

FVM issues specific to financial liabilities

demand features

- » Fair value of a financial liability with demand features cannot be less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 47 of IFRS 13).

60

60



Fair value: derivative liabilities

61




Measuring the fair value of derivative assets and derivative liabilities

- » For **exchange-traded** derivatives in active markets: measure fair value using unadjusted quoted market prices.
- » For **non-exchange-traded** derivatives: following the income or market approach measure fair value using a valuation technique incorporating market participant assumptions. For example, the fair value of a basic swap could be measured by:
 - » **market approach**: by obtaining accommodation quotes from dealers (with appropriate testing performed by the reporting entity)
 - » **income approach**: by a discounted cash-flow analysis based on available forward yield curves for plain-vanilla swaps of the same type

62

62



Fair value of JSE listed debt instruments mini-case study 1: a regulators ruling: JSE (South Africa) (emphasis added)

Matter 4 (2016)

An issuer had entered into various interest rate swaps, which were accounted for as cash flow hedges. Whilst **correctly accounting for the fair value consequences** for these derivative instruments, the issuer **neglected to consider the deferred tax consequences** thereof. Not only did this result in other **comprehensive income being overstated**, but the case also concerned us in that there were no accounting processes in place to ensure that the tax consequences for all class of assets had been considered.

Source: Combined findings of the JSE proactive monitoring of financial statements, 28 October 2022, p37 ⁶³

63



Regulatory rulings and mini-case studies

64

Financial statement compliance review issues identified by FRC (UK) (emphasis added) *Banks financial liability classification and measurement issues*

- » For **financial instruments designated FVPL**, most banks listed the criteria from the standard but **did not explain how the criteria had been met**.
- » Entity with significant financial liabilities **designated at FVPL** recognising changes in fair value attributable to changes in own credit risk through OCI. The **accounting policy did not discuss the treatment of gains and losses attributable to changes in own credit risk**.
- » **Boilerplate language** which was generic and quoted directly from the standard.

Source: FRC (UK), IFRS 9 Thematic Review: Review of Disclosures in the First Year of Application (2019), p12 65

65

Financial statement compliance review issues identified by FRC (UK) (emphasis added) *Summary of class discussion*

“Similarly, to reduce accounting mismatches, the Group has **designated certain financial liabilities at fair value through profit or loss** where the liabilities either:

- » Have fixed rates of interest and interest rate swaps or other interest rate derivatives have been entered with the intention of significantly reducing interest rate risk; or
- » Are exposed to foreign currency risk and derivatives have been acquired with the intention of significantly reducing exposure to market changes; or
- » Have been acquired to fund trading asset portfolios or assets.

Financial liabilities may also be designated at fair value through profit or loss where they are managed on a fair value basis or have a embedded derivative where the Group is not able to bifurcate and separately value the embedded derivative component.” Standard Chartered plc, p266

Is the company’s explanation of the basis on which financial liabilities are designated at FVPL: 1) inadequate; or 2) adequate?

Source: FRC (UK), IFRS 9 Thematic Review: Review of Disclosures in the First Year of Application (2019), p12 67

67