

IFRS Accounting Standards discussion fora: IFRS 9 *Financial Instruments*

2023

Addis Ababa, Ethiopia



WORLD BANK GROUP

AABE

Accounting and Audit Board of Ethiopia
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Aims

- » Develop a more cohesive understanding of IFRS accounting and reporting for financial instruments in Ethiopia
- » Enhance capacity in Ethiopia to apply IFRS 9 *Financial Instruments* more consistently

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Applicable version of IFRS Accounting Standards

Unless specified otherwise, the accounting requirements that are the subject matter of this discussion forum are IFRS Accounting Standards as issued by the International Accounting Standards Board 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.

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Index of issues
IFRS 9 Financial Instruments

- » Classification and measurement
- » Expected credit losses



Classification and Measurement



Index of issues *IFRS 9 Financial Instruments*

Classification & measurement

- » Issue 1: Effective interest rate
- » Issue 2: Internal rate of return
- » Issue 3: Alternative to internal rate of return
- » Issue 4: Incremental borrowing rate
- » Issue 5: Off market loans
- » Issue 6: Foreign loans – present value

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Issue 1: Effective interest rate

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Effective interest rate

What do you think?

IFRS 9 defined 'effective interest rate' and requires it to be applied to determine annual interest and transaction costs on financial instruments measured at amortized cost.

For loans measured at amortised cost, IFRS 9 requires considering the principal, interest and transaction costs to work out the effective interest rate. Can IRR can be used as an effective rate?

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Effective interest rate

Summary of discussion

For loans measured at amortised cost, IFRS 9 requires considering the principal and interest to work out the effective interest rate. Can IRR can be used as an effective rate?

Discussants' consensus view: Yes³

» **EIR is defined as:**

- » **The rate that exactly discounts estimated future cash flows to the gross carrying amount of the asset or liability¹**
- » **Future cash flows include fees paid or received that are an integral part of the interest rate²**

» **This is internal rate of return (the terms are interchangeable)**

¹ IFRS 9 – definitions

² IFRS 9.B5.4.1 to B5.4.3

³ Note however, if the financial instrument is low or zero interest, it necessary to first determine the fair value of the loan 10

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Issue 2: Effective interest rate

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Internal rate of return *What do you think?*

There are a number of tools for determining internal rate of return. The most available calculator that can also produce an audit trail is Microsoft excel.

**How do you calculate
Internal rate of return?**

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Internal rate of return

Summary of discussion

How do you calculate Internal rate of return?

Discussants' consensus view

» Refer example on the next slide

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Example

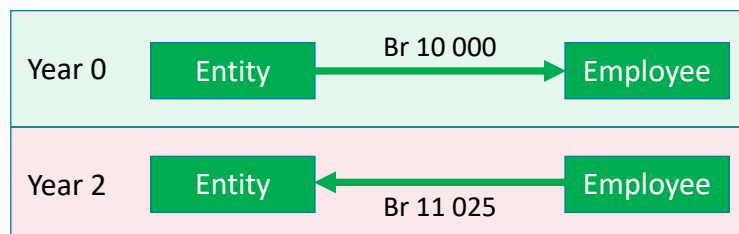
Amortised cost - internal rate of return

Entity grants a loan to a member of staff:

» Loan amount is Br10 000

» Loan is issued at a market rate

» Loan repayable in single instalment of Br11 025 in 2 years time



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Example *Amortised cost - internal rate of return*

	A (description)	B (cash flows)
1	Begin year 1 – cash outflow	(10 000)
2	End year 1 – no cash flow	0
3	End year 2 - repayment	11 025
4	Internal rate of return	5.0%

Using Excel to
calculate internal
rate of return

Cell B4
contains:
`=IRR(B1:B3)`

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Issue 3: Alternative to EIR

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Alternative to EIR

What do you think?

IFRS 9 requires an entity to calculate the Effective interest rate (EIR) for financial instruments measured at amortized cost. EIR is equivalent to internal rate of return.

Can we use the contractual borrowing rate to discount future cash flows?¹

¹ Contractual rate is read here to mean the rate in the contract being measured

Alternative to EIR

Summary of discussion

Can we use contractual borrowing rate to discount future cash flows?

Discussants' consensus view: It depends

- » **For many, if not most contracts, the charges are explicit and appropriate:**
 - » **Fees charged represent compensation for actual services provided**
 - » **Interest rate represents compensation for time value of money and associated risks, and is calculated in a conventional manner**
 - » **In such circumstance, the contractual borrowing rate is usually equal to IRR and EIR**
- » **However, in some contracts, the fee is excessive and is a method for recovering additional time value of money (see next slide)**

Alternative to EIR

Summary of discussion *continued*

Can we use contractual borrowing rate to discount future cash flows?

Discussants' consensus view: It depends

- » IFRS 9.B5.4.1 requires an entity identify 'fees that are an *integral part of the EIR*'. For contracts at amortized cost, these fees adjust the EIR
- » IFRS 9.B5.4.2 lists examples of fees that are an *integral part*:
 - » Origination fees related to creating or acquiring the asset
 - » Commitment fees where it is probably a loan will be advanced
- » IFRS 9.B5.4.3 list examples of fees that are not an integral part, including fees charged for actual service provided
- » If fees are an integral part of EIR, then EIR/IRR must be calculated

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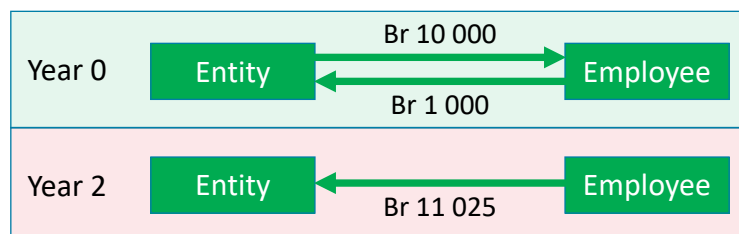
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Example

Amortised cost – Effective interest rate

Entity grants a loan to a member of staff:

- » Loan amount is Br10 000
- » Loan bears interest at 5% per year
- » Staff member pays Br1 000 as an origination fee, on loan grant
- » Loan repayable in single instalment of Br11 025 in 2 years time



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Example *Amortised cost – effective interest rate*

	A (description)	B (cash flows)
1	Begin year 1 – net cash outflow (-10 000 + 1 000)	(9 000)
2	End year 1 – no cash flow	0
3	End year 2 - repayment	11 025
4	Internal rate of return	10.7%

Using Excel to calculate internal rate of return

Cell B4 contains:
`=IRR(B1:B3)`

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Issue 4: Incremental borrowing rate

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Incremental borrowing rate

What do you think?

A number of IFRS Accounting Standards require an entity to calculate the incremental borrowing rate. This is typically the case when the contractual¹ or implicit interest rate is not available, for example in certain leases.

Can we use the bank loan borrowing rate to discount future cash flows?²

¹ For example, a lease of office space may not include a contractual interest rate

² Bank loan borrowing rate is read here to mean a rate that is not included in the contract

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Incremental borrowing rate

Summary of discussion

Can we use the bank loan borrowing rate to discount future cash flows?

Discussants' consensus view: It depends

- » In specified circumstances, incremental borrowing rate (IBR) is used as a relief when the rate implicit in a contract cannot be calculated
- » It is a last resort
- » The IBR is defined as the rate 'a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment' (IFRS 16, appendix A definitions)
- » A bank borrowing rate may meet this criteria but judgement is required

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Issue 5: Off-market loans

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Off-market loans *What do you think?*

An entity is generally required to initially recognise a financial asset or liability at its fair value plus or minus¹ transaction costs directly attributable to the acquisition or issue of the financial asset or financial liability.²

We make loans at times at a beneficial (off market) interest rate. How do we account for these loans?

¹ In the case of a financial asset or financial liability not at fair value through profit or loss

² IFRS 9.5.1.1

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Off market loans

Summary of discussion

We make loans at times at a beneficial (off market) interest rate. How do we account for these loans?

Discussants' consensus view

- » The loan is accounted for at fair value at initial recognition (typically the present value of expected cash flows discounted using the market rate)
- » IFRS 9.B5.1.1 requires an immediate expense be recognized for the difference between the loan and its fair value, unless the difference qualifies for recognition as another type of asset
- » EIR is then the market rate, and interest is unwound at that EIR

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Example

Off-market loans

- » Entity makes a Br100 000 loan to a member of staff
- » Market interest rate is 10%, staff loans are advanced to eligible staff at 5%
- » Loans are repayable in 60 equal monthly instalments of Br1 887

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Example Off-market loans

	A (description)	B (cash flows)
1	Monthly payments	1 887
2	Interest rate	10%
3	Monthly interest rate	0.8333%
4	# of Installments	60
5		88 818

Using Excel to
calculate Present
Value

Cell B5
contains:
=PV(B3,B4,B1)

Cash advance of Br100 000, less initial loan of Br88 818
equals:
Br 11 182 cost of off-market loan

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Example - Off-market loans Summary of discussion *continued*

How should the difference be accounted for?

Discussants' consensus view

- » If the loan binds staff member to remain employed for a period or provide some other future service, then the cost must be recognized as an expense over the future service period of the related future service
- » Otherwise the expense is recognised immediately

Example <i>continued</i>	Debit	Credit
Dr Loan to staff	88 818	
Dr Staff expense	11 182	
Cr Cash balance		100 000

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Example
Off-market loans – First month of accounting

	Debit	Credit
Dr Loan to staff	740	
Cr interest received (88 818 x 10% x 1/12)		740
Dr Cash balance	1 887	
Cr Loan to staff		1 887

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Issue 6: Foreign loans - Present Value

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Foreign loans – present value

What do you think?

Present value calculation are frequently required in IFRS Accounting Standards, usually as a mechanism for establishing the inception value of an asset or liability that is not contractual in nature, or that is not at a market related rate.

We have foreign loans where we pay principal and interest quarterly. How should we workout the Present Value of the loan balance?

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Foreign loans – present value

Summary of discussion

We have foreign loans where we pay principal and interest quarterly. How should we workout the Present Value of the loan balance?

Discussants' consensus view

- » A foreign loan is a *monetary item* as defined in IAS 21
- » Consequently, it is managed throughout its contractual life in the currency in which the instrument is denominated, and converted to functional currency at each reporting date
- » Present value would therefore be measured in the foreign currency, considering all cash flows in that currency
- » See example next slide

¹ IAS 21.8

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Example Present value - Foreign loan

- » Entity borrows USD100 000 from an aid agency
- » Market interest rate is 10%, however the loan is advanced at 5%
- » The loan is repayable in 20 equal quarterly instalments of USD5 682
- » There are no other conditions to the loan
- » The exchange rate at commencement of the loan is Br50:USD1
- » Loan is advanced on 7 July 2022, the last day of the financial year

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Example Present value - Foreign loan

	A (description)	B (cash flows)
1	Monthly payments	USD5 682
2	Market interest rate	10%
3	Quarterly interest rate	2.5%
4	# of Installments	20
5	Present value	USD88 578

Using Excel to
calculate Present
Value

Cell B5
contains:
=PV(B3,B4,B1)

If the present value is translated to Br on 7 July 2022:
88 578 x 50 = Br4 428 911

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Issue 7: Derecognition of financial assets

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Derecognition of financial assets *What do you think?*

IFRS 9 establishes requirements for the derecognition of financial assets and liabilities.

Write-off of financial assets in the books of SOEs are constrained by strict regulation. How should these assets be accounted for if they are long-outstanding?

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Derecognition of financial assets

Summary of discussion

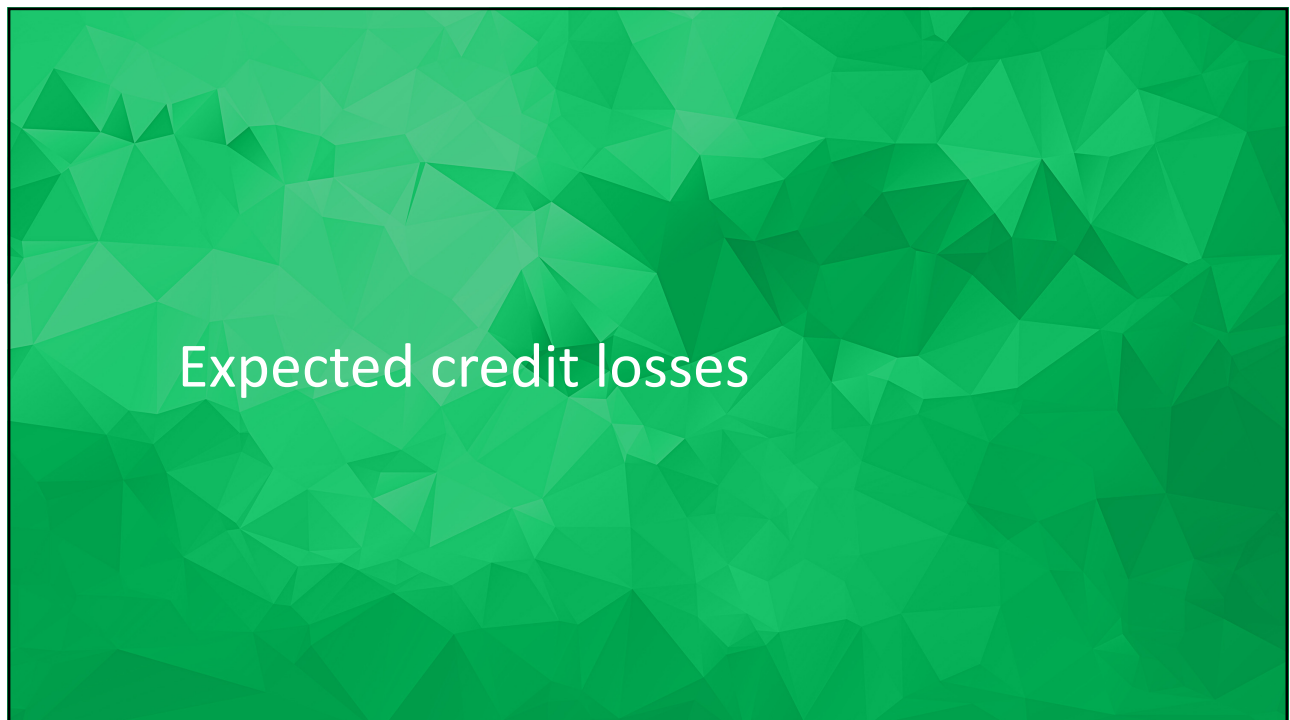
Write-off of financial assets in the books of SOEs are constrained by strict regulation. How should these assets be accounted for if they are long-outstanding?

Discussants' consensus view

- » IFRS 9.5.4.9 requires that an entity should write off an asset in whole or part when it has no reasonable expectation of recovering the asset
- » If the SOE has no reasonable expectation of recovering long outstanding assets (highly likely), then these assets should be written off *in its IFRS financial statements*
- » This does not require the entity to write off the assets in its primary books of record if this is prohibited by law

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Index of issues *IFRS 9 Financial Instruments*

Expected credit losses (ECL)

- » Issue 1: ECL – Non-bank loans and advances
- » Issue 2: ECL – Cash at bank
- » Issue 3: ECL – Cash at bank
- » Issue 4: ECL – Macroeconomic factors
- » Issue 5: ECL – Loan commitments
- » Issue 6: ECL – Fully collateralized loans
- » Issue 7: ECL – Unavailable data

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Issue 1: Expected credit losses – non-bank loans and advances

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Expected credit losses - non-bank lending

What do you think?

IFRS 9 requires a loss allowance for expected credit losses (ECL) for all financial assets measured at amortized cost and debt instruments measured at fair value through other comprehensive income.¹

Does an entity need to work out ECL for staff receivables, prepayments or advance payments?

¹ IFRS 9.5.5.1

Expected credit losses - non-bank lending

Summary of discussion

» Does an entity need to work out ECL for staff receivables, prepayments or advance payments?

Discussants' consensus view:

- » IFRS 9.5.5.1 requires a loss allowance for expected credit losses be calculated for financial assets (including loan commitments and contract assets) measured at amortized cost and debt instruments at fair value OCI
- » If the assets are classified as financial assets, then the calculation of ECL is necessary for all of them
- » IFRS 9 includes a simplified approach for determining ECL (IFRS 9.5.5.15) – some of the balances referred to above may be eligible



Issue 2: Expected credit losses – Cash at bank

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Expected credit losses – cash at bank *What do you think?*

IFRS 9 requires a loss allowance for expected credit losses (ECL) for all financial assets measured at amortized cost and debt instruments measured at fair value through other comprehensive income.¹

Is calculation of ECL on cash balances held at banks a mandatory requirement under IFRS?

¹ IFRS 9.5.5.1

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Expected credit losses – cash at bank

Summary of discussion

Is calculation of ECL on cash balances held at banks a mandatory requirement under IFRS?

Discussants' consensus view: Yes¹

- » IFRS 9.5.5.1 requires a loss allowance for expected credit losses be calculated for financial assets (including loan commitments and contract assets) measured at amortized cost and debt instruments at fair value OCI
- » Cash balances held at banks are a financial asset, and are typically carried at amortized cost applying IFRS 9 requirements
- » Consequently, they are subject to the requirements of IFRS 9.5.5.1

¹ Subject to materiality



Issue 3: Expected credit losses – cash at bank

Expected credit losses – cash at bank

What do you think?

IFRS 9 requires a loss allowance for expected credit losses (ECL) for all financial assets measured at amortized cost and debt instruments measured at fair value through other comprehensive income.¹

What are the possible measurement methods available for impairment on cash and cash equivalents?

¹ IFRS 9.5.5.1

Expected credit losses – cash at bank

Summary of discussion

What are the possible measurement methods available for impairment on cash and cash equivalents?

Discussants' consensus view

- » **Cash at bank will likely not be eligible for the simplified ECL approach**
- » **Consequently, ECL will be determined applying the deterioration model (briefly described in the following slides)**
- » **Applying that model, cash at bank:**
 - » **will typically be considered stage 1 (performing as expected)**
 - » **will usually have a short contractual period and a short behavioral period**
 - » **will typically have a very low probability of default over that period**

Expected credit losses – cash at bank

Some important terms

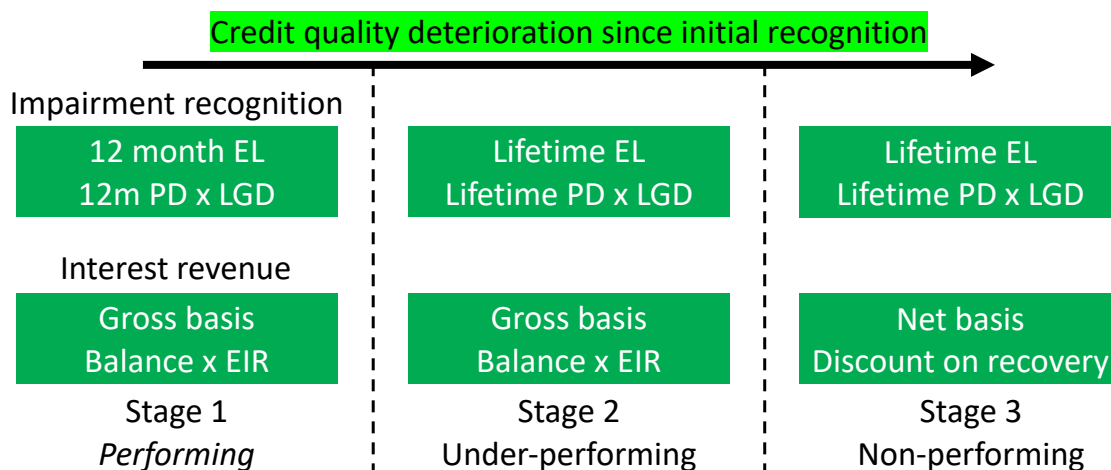
- » Probability of default: the likelihood that a bank will default on its obligations in a defined future period
- » Default: Bank has reneged on its obligations, usually by missing a payment but may also be missed debt covenants, liquidation etc
- » Loss given default: How much you expect to lose if a bank defaults
- » Exposure at default: How much will you be owed when bank defaults

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Expected credit losses – cash at bank

Overview of the deterioration model



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Issue 4: Expected credit losses - macroeconomic factors

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Expected credit losses - macroeconomic factors *What do you think?*

IFRS 9 requires the calculation of Expected credit losses using all relevant, reasonable and supportable forward-looking information available without undue cost or effort.¹

What macroeconomic factors should be considered to measure expected credit loss- especially by banks?

¹ IFRS 9.5.5.11

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Expected credit losses - macroeconomic factors

Summary of discussion

What macroeconomic factors should be considered to measure expected credit loss-especially by banks?

Discussants' consensus view

- » IFRS 9.5.5.11 refers
- » Include information about past events, current conditions and forecasts of future economic conditions
- » Data sources can be internal or external (ratings, statistics or reports)
- » Relevant macroeconomic factors that may be available: house price indexes, GDP growth, household debt ratios, inflation, interest rates, exchange rate, wage inflation, taxation, global events

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Issue 5: Expected credit losses - loan commitments

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Expected credit losses - loan commitments

What do you think?

IFRS 9 requires a loss allowance for expected credit losses (ECL) for specified financial assets, explicitly including loan commitments.

Why it is necessary to calculate ECL on loans not yet disbursed (loan commitments)

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Relying on experts

Summary of discussion

Why it is necessary to calculate ECL on loans not yet disbursed (loan commitments)

Discussants' consensus view

- » A loan commitment is recognised for the purposes of applying impairment requirements when it becomes irrevocable¹
- » An irrevocable loan commitment is one in which the grantor has no choice but to grant the committed loan on satisfaction of agreed conditions
 - » This, the loan may be obliged even after default of grantee
 - » Consequently, the grantor is exposed to credit risk
- » Loss given default considers circumstances in which loan can be refused

¹ IFRS 9.5.5.6

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Issue 6: Expected credit losses – fully collateralized loans

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Expected credit losses – fully collateralised loans *What do you think?*

IFRS 9 requires a loss allowance for expected credit losses (ECL) for all financial assets measured at amortized cost and measured at fair value through other comprehensive income. It explicitly includes fully collateralised loans.

We have fully collateralised financial assets with no default history. How can we determine the LGD percentage? Are these assets subject to ECL? Are we allowed to use the minimum Basel category? Is discounting to present value the only option to determine the default?

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Expected credit losses – fully collateralised loans

Summary of discussion

We have fully collateralised financial assets with no default history. How can we determine the LGD percentage?

Discussants' consensus view

- » Loss given default is determined considering all future expected cash flows, risk weighted and adjusted for time value
- » For a collateralised financial asset, these future cash flows will include the expected recovery of the value of the collateral
- » It is possible, but unusual, that the cash flow from collateral will exceed the value of the loan in all scenarios – if it does, then LGD will be zero
- » Note: Irrespective of LGD, the loan is still staged based on deterioration

See also IFRS 9 Illustrative example 3

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Expected credit losses – fully collateralised loans

Summary of discussion

We have fully collateralised financial assets with no default history. Are these assets subject to ECL?

Discussants' consensus view: Yes

- » IFRS 9 ECL model operates in steps:
 1. Consider the performance of the loan and whether it should be staged
 2. Considering the level of staging, calculate the expected credit loss
 3. Create a loss allowance for the expected credit loss
- » There is valid credit risk and risk mitigation information in each step
- » Thus even if LGD is expected to be zero, there is useful data in step 1
- » Note also: It is unusual that LGD is zero under all scenarios

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Expected credit losses – fully collateralised loans

Summary of discussion

We have fully collateralised financial assets with no default history. Are these assets subject to ECL?

Discussants' consensus view: simplified example to consider

	Scenario (outstanding loan Br1 million)	Probability (prob)	Present Value (PV) ²	PV x Prob
1	Collateral recovered (PV Br1.5 m) ¹	10%	1 000 000	100 000
2	Collateral recovered (PV Br1.1 m) ¹	85%	1 000 000	850 000
3	Collateral recovered (PV Br0.9 m)	5%	900 000	45 000
	Expected value of recovery			995 000
	Loss given default			5 000

¹ Recoveries capped at value of loan

² Measured using the original EIR

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Expected credit losses – fully collateralised loans

Summary of discussion

We have fully collateralised financial assets with no default history. Are we allowed to use the minimum Basel category?

Discussants' consensus view: No¹

- » The Basel categories are typically more generic in nature (they do not take into consideration all economic and entity specific relevant factors)
- » They may be materially correct when applied to a portfolio
- » An entity would need to make a judgement on whether the categories appropriately and materially reflect the circumstances of their particular loan or portfolio of loans.

¹ Subject to materiality

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Expected credit losses – fully collateralised loans

Summary of discussion

We have fully collateralised financial assets with no default history.
Is discounting to present value the only option to determine the default?

Discussants' consensus view: It depends

- » In certain circumstances, the collateral may be immediately available, may itself be interest bearing (eg an interest-bearing deposit), or may increase in value over time (eg a zero-bond approaching maturity)
- » In these circumstances, the effect of discounting may not be material

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Issue 6: Expected credit losses – Unavailable data

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Expected credit losses – Unavailable data

What do you think?

IFRS 9 requires the calculation of Expected credit losses using all relevant, reasonable and supportable forward-looking information available without undue cost or effort.¹

It is difficult to obtain data for some industries due to lack of previous analysis or trend. Is there any other method to estimate credit losses?

¹ IFRS 9.5.5.11

Expected credit losses – Unavailable data

Summary of discussion

It is difficult to obtain data for some industries due to lack of previous analysis or trend. Is there any other method to estimate credit losses?

Discussants' consensus view

- » An entity is required to use all relevant, reasonable and supportable forward-looking information available without undue cost or effort
- » An entity cannot ignore information reasonably available
- » If no information is available, entities typically use:
 - » Historical information from statistical sources eg central bank
 - » Historical or other information available from international experience (rating agencies, World Bank etc) that is relevant

