Financial Instruments
A summary of IFRS 9 and its effects
March 2017
Overview of IFRS 9 Financial Instruments

- Financial asset classification based on business model and contractual cash flows test
- Financial liability accounting largely unchanged
- Impairment model amended from incurred to expected credit losses
- Hedge accounting aligned to how the entity manages the risks
**Business model test**

- Change in circumstances
- Relevant information
  - Performance evaluation & reporting
  - Risks & risk management
  - Remuneration
- Unit of account
  - Items managed together
  - Portfolio segmentation
- Type of objective
  - Collection of cash flows
  - Relevance of sales

**Contractual cash flow characteristics test**

- Contractual undiscounted cash flows
- Compare
- Undiscounted cash flows of the benchmark

  - Non-SPPI feature in the financial asset which is *de minimis* or non-genuine?
  - Is the time value element of the interest rate modified?
  - Other components of interest consistent with basic lending-type return?
  - Is there a prepayment feature at par?
  - Is the FV of the feature insignificant at initial recognition?

**Key terms and abbreviations**

- FV: Fair value
- FVOCI: Fair value through other comprehensive income
- FVTPL: Fair value through profit or loss
- SPPI: Soley payments of principal and interest
- EIR: Effective interest rate
- ECL: Expected credit loss
Background

The International Accounting Standards Board (IASB or Board) published the final version of IFRS 9 Financial Instruments (IFRS 9) in July 2014. This document provides a brief overview of IFRS 9, with an emphasis on the major changes from the current standard IAS 39 Financial Instruments: Recognition and Measurement (IAS 39).

IFRS 9 is effective for annual periods beginning on or after 1 January 2018 and shall be applied retrospectively (with a few exceptions). However, the Standard is available for early application. In addition, the new requirements for presenting fair value changes due to an entity’s own credit risk can be early applied in isolation without adopting the remaining requirements of the standard.

What you need to know

The new standard contains substantial changes from the current financial instruments standard (IAS 39) with regards to the classification, measurement, impairment and hedge accounting requirements which will impact many entities across various industries.

There are changes to the three main sections of IFRS 9:

1. **Classification and measurement** - The new classification requirements are based on both the entity’s business model for managing the financial assets and the contractual cash flow characteristics of a financial asset. The more principles-based approach of IFRS 9 requires the careful use of judgment in its application.

2. **Impairment** - The IASB has sought to address a key concern that arose as a result of the financial crisis, that the incurred loss model in IAS 39 contributed to the delayed recognition of credit losses. As such, it has introduced a forward-looking expected credit loss model.

3. **Hedge accounting** - The aim of the new hedge accounting model is to provide useful information about risk management activities that an entity undertakes using financial instruments, with the effect that financial reporting will reflect more accurately how an entity manages its risk and the extent to which hedging mitigates those risks.

IFRS 9 is effective for annual periods beginning on or after 1 January 2018 and shall be applied retrospectively (with a few exceptions).
Impact of adoption of IFRS 9

The following diagram illustrates the potential impact of the adoption of IFRS 9 on specific industries:
Classification and measurement of financial assets

Classification determines how financial assets are categorised and measured in the financial statements. Requirements for classification and measurement are thus the foundation of the accounting for financial instruments.

The requirements for impairment and hedge accounting are also based on this classification.

Financial assets are classified in their entirety rather than being subject to complex bifurcation requirements. There is no separation of embedded derivatives from financial assets under IFRS 9.

The new standard effectively sets out three major classifications; namely amortised cost (AC), fair value through profit or loss (FVTPL) and fair value through other comprehensive income (FVOCI).
Debt instruments

The classification is based on both the entity’s business model for managing the financial assets and the characteristics of the financial asset’s contractual cash flows. There are 3 classifications of debt financial assets:

**Amortised cost**

Amortised cost applies to instruments for which an entity has a business model to hold the financial asset to collect the contractual cash flows. The characteristics of the contractual cash flows are that of solely payments of the principal amount and interest (referred to as “SPPI”).

- **Principal** is the fair value of the instrument at initial recognition.
- **Interest** is the return within a basic lending arrangement and typically consists of consideration for the time value of money, and credit risk. It may also include consideration for other basic lending risks such as liquidity risk as well as a profit margin.

**Fair value through other comprehensive income**

Fair value through other comprehensive income is the classification for instruments for which an entity has a dual business model, i.e. the business model is achieved by both holding the financial asset to collect the contractual cash flows and through the sale of the financial assets. The characteristics of the contractual cash flows of instruments in this category, must still be solely payments of principal and interest.

The changes in fair value of FVOCI debt instruments are recognised in other comprehensive income (OCI). Any interest income, foreign exchange gains/losses and impairments are recognised immediately in profit or loss. Fair value changes that have been recognised in OCI are recycled to profit or loss upon disposal of the debt instrument.

**Fair value through profit or loss**

Fair value through profit or loss is the classification of instruments that are held for trading or for which the entity’s business model is to manage the financial asset on a fair value basis i.e. to realise the asset through sales as opposed to holding the asset to collect contractual cash flows. This category represents the ‘default’ or ‘residual’ category if the requirements to be classified as amortised cost or FVOCI are not met. All derivatives would be classified as at FVTPL.

Even though an entity’s financial assets may meet the criteria to be classified at amortised cost or as an FVOCI financial asset an entity may, at initial recognition, designate a financial asset as measured at FVTPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.
Equity instruments

**Fair value through other comprehensive income**
On initial recognition, an entity may make an **irrevocable election** (on an instrument-by-instrument basis) to designate an equity instrument at FVOCI. This option only applies to instruments that are not held for trading and are not derivatives.

Although most gains and losses on investments in equity instruments designated at FVOCI will be recognised in OCI, dividends will normally be recognised in profit or loss (unless they represent a recovery of part of the cost of the investment).

Gains or losses recognised in OCI are never reclassified from equity to profit or loss. Consequently, there is no need to review such investments for possible impairment. The FVOCI equity reserves may however be transferred within equity i.e. to another component of equity, if the entity so chooses.

**Fair value through profit or loss**
Equity instruments are normally measured at FVTPL. All derivatives would be classified as at FVTPL.
2. Classification and measurement of financial liabilities

The classification of financial liabilities under IFRS9 does not follow the approach for the classification of financial assets; rather it remains broadly the same as under IAS 39. Financial liabilities are measured at amortised cost or fair value through profit or loss (when they are held for trading). Financial liabilities can be designated at FVTPL if managed on a fair value basis or eliminates or reduces an accounting mismatch- refer to above on financial assets.

For financial liabilities designated as at FVTPL using the fair value option, the element of gains or losses attributable to changes in the entity’s own credit risk should normally be recognised in OCI, with the remainder recognised in profit or loss. These amounts recognised in OCI are not recycled to profit or loss if the liability is ever repurchased at a discount. However, if presentation of the fair value change in respect of the liability’s credit risk in OCI creates or enlarges an accounting mismatch in profit or loss (for example if an entity expects the effect of the change in the liability’s credit risk to be offset by the fair value of a financial asset), gains and losses must be entirely presented in profit or loss.

3. Reclassification

In certain rare circumstances an entity may change its business model for managing financial assets. When and only when this happens, it shall prospectively reclassify all affected financial assets, unless irrevocably designated at initial recognition. This is not expected to be frequent. If, at all, it happens it will be a significant change to the entities business operations and this should be demonstrable to external parties. An example would be if an entity acquires a new business line and the financial assets will be managed on a difference basis in line with the new business model.

An entity shall not reclassify any financial liability.

In certain rare circumstances an entity may change its business model for managing financial assets.
Impairment

The IASB has sought to address a key concern that arose as a result of the financial crisis that the incurred loss model in IAS 39 contributed to the delayed recognition of credit losses. As such, it has introduced a forward-looking expected credit loss model.

The guiding principle of the expected credit loss (ECL) model is to reflect the general pattern of deterioration or improvement in the credit quality of financial instruments. The amount of ECLs recognised as a loss allowance or provision depends on the extent of credit deterioration since initial recognition. Under the general approach, there are two measurement bases:

- **12-month ECLs (Stage 1)**, which applies to all items (from initial recognition) as long as there is no significant deterioration in credit quality.
- **Lifetime ECLs (Stages 2 and 3)**, which applies when a significant increase in credit risk has occurred on an individual or collective basis.

If financial assets become credit-impaired (Stage 3 in illustration below) interest revenue would be calculated by applying the effective interest rate (EIR) to the amortised cost (net of the impairment allowance) rather than the gross carrying amount.

Financial assets are assessed as credit-impaired using the same criteria as for the individual asset assessment of impairment under IAS 39.
There are two alternatives to the general approach:

- **The simplified approach**, that is either required or available as a policy choice for trade receivables, contract assets and lease receivables. The simplified approach does not require the tracking of changes in credit risk, but instead requires the recognition of lifetime ECL at all times. For trade receivables or contract assets that do not contain a significant financing component (as determined in terms of the requirements of IFRS 15 *Revenue from Contracts with Customers*), entities are required to apply the simplified approach. For trade receivables or contract assets that do contain a significant financing component, and lease receivables, entities have a policy choice to apply the simplified approach.

- **The credit-adjusted EIR approach**, for purchased or originated credit-impaired financial assets. For financial assets that are credit-impaired on purchase or origination, the initial lifetime ECL would be reflected in a credit-adjusted EIR, rather than recording a 12-month ECL. Subsequently, entities would recognise in profit or loss, the amount of any change in lifetime ECL as an impairment gain or loss.

### Measurement of ECLs

Lifetime ECL would be estimated based on the present value of all cash shortfalls over the remaining life of the financial instrument. The 12-month ECL is a portion of the lifetime ECL that is associated with the probability of default events occurring within the 12 months after the reporting date.

‘Default’ is not defined and the standard is clear that default is broader than failure to pay and entities would need to consider other qualitative indicators of default (e.g., covenant breaches). There is also a rebuttable presumption that **default does not occur later than 90 days past due**.

ECLs are an estimate of credit losses over the life of a financial instrument and when measuring ECLs, an entity needs to take into account:

- The probability-weighted outcome
- The time value of money so that ECLs are discounted to the reporting date
- Reasonable and supportable information that is available without undue cost or effort

### Assessing whether there has been a significant deterioration in credit risk

There are a number of operational simplifications and presumptions are available to help entities assess significant increases in credit risk since initial recognition. These include:

- A **rebuttable presumption** that credit risk is deemed to have significantly increased if an amount is **30 days past due**.

- If a financial instrument has **low credit risk** (equivalent to investment grade quality), then an entity may assume no significant increases in credit risk have occurred.
Hedge accounting

Types of hedges

Hedge accounting in IFRS 9 still consists of the same three types of hedge accounting that exists currently under IAS 39:

- cash flow hedge
- fair value hedge
- hedge of a net investment in a foreign operation.

The mechanics of hedge accounting have also broadly remained the same in terms of the how the hedging instrument and hedged item would be accounted for. Hedge accounting remains optional and can only be applied to hedging relationships that meet the qualifying criteria. However, what has changed is what qualifies for hedge accounting. This includes replacing some of the arbitrary rules with more principle-based requirements and allowing more hedging instruments and hedged items to qualify for hedge accounting. Overall, this should result in more risk management strategies qualifying for hedge accounting.

The changes that have been made to hedge accounting have been made to achieve the following objective:

- To align the accounting for hedges more closely with the risk management strategy of an entity
- Improve the disclosure of information about risk management activities.

An entity is required to document the following for its hedging relationship to qualify for hedge accounting:

1. Eligible hedging instrument and hedged item (in their entirety or components thereof).
2. Risk management objective and strategy for undertaking the hedge.
3. The nature of the risk being hedged.
4. How the entity will assess whether the hedging relationship meets the hedge effectiveness requirements.
Requirements for hedge accounting

IFRS 9 introduces the following hedge effectiveness requirements:

1. There must be an economic relationship between the hedged item and the hedging instrument;
2. The effect of credit risk must not dominate the value changes that result from that economic relationship; and
3. The hedge ratio of the hedging relationship must be the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness.

The hedge ratio may be adjusted if the hedging relationship no longer meets the hedge effectiveness requirement and the risk management objective has remained the same, referred to as “rebalancing”, so that it meets the criteria again.

Key changes from IAS 39

Hedge effectiveness testing

- This is prospective only and can be qualitative, depending on the complexity of the hedge. The 80-125% range is replaced by an objectives-based test that focuses on the economic relationship between the hedged item and the hedging instrument, and the effect of credit risk on that economic relationship.

Risk component

- This may be designated as the hedged item, not only for financial items, but also for non-financial items, provided the risk component is separately identifiable and reliably measurable.

Costs of hedging

- The time value of an option, the forward element of a forward contract and any foreign currency basis spread can be excluded from the designation of a financial instrument as the hedging instrument and accounted for as costs of hedging.
- This means that, instead of the fair value changes of these elements affecting profit or loss like a trading instrument, these amounts get allocated to profit or loss similar to transaction costs (which can include basis adjustments), while fair value changes are temporarily recognised in other comprehensive income (OCI).

Disclosures

- These are more extensive and require the provision of more meaningful information and insights.
Transition

IFRS 9 is mandatorily applicable for periods beginning on or after 1 January 2018. IFRS 9 contains a general requirement that it should be applied retrospectively, although it also specifies a number of exceptions which are considered below. An entity may restate prior periods if, and only if, it is possible without the use of hindsight.

Where prior periods are not restated, any difference between the previous reported carrying amounts and the new carrying amounts of financial assets and liabilities at the beginning of the annual reporting period should be recognised in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period when IFRS 9 is first applied. However, if an entity restates prior periods, the restated financial statements must reflect all of the requirements in IFRS 9.
## Restatement optional

If an entity restates its comparatives, it should not apply the standard to financial assets or financial liabilities that have already been derecognised at the date of initial application.

The 2017 comparative will therefore be prepared on a mixed basis with some instruments under IAS 39 and the rest under IFRS 9.

## If no restatement

Adjustment to equity to reflect difference between carrying amounts under IAS 39 and carrying amounts under IFRS 9.

## First year end under IFRS 9

### Classification and measurement - specific transition requirements

#### Pre-2017

The contractual cash flow characteristics of an asset should be assessed based on conditions at the date of initial recognition, not at the date of initial application.

#### Business model assessment

Entities should make the business model assessment on the basis of the facts and circumstances that exist at the date of initial application (1 January 2018). The resulting classification should be applied retrospectively, irrespective of the entity’s business model in prior reporting periods.

#### First year end under IFRS 9

### Impact on interim reporting periods

Where interim financial reports are prepared in accordance with IAS 34, the requirements in IFRS 9 need not be applied to interim periods prior to the date of initial application, if it is impracticable to do so.

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1. If it is impracticable (as defined in IAS 8) to assess any modified time value of money element or prepayment feature, then the asset would most likely be classified at fair value through profit and loss.
2. As applicable to entities with 31 December year ends.
Impact of adoption of IFRS 9 for financial institutions

The effect of IFRS 9 will need to be assessed on the facts and circumstances relevant to each entity. This will be impacted by the types and complexity of financial assets and financial liabilities of the entity. The extent of the provision of credit and the types of loans originated and/or purchased will have a significant impact on the complexity of the impairment model.

In addition, the extent to which hedges are used to manage risks within the entity will determine the impact of the hedging changes to the standard. It is expected that certain industries will be more significantly impacted than others. Some of the considerations are:

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### Retail Banking

#### Impairment
- Implementation of new expected credit loss model
- Impairment for off statement of financial position items (loan commitments, financial guarantee contracts)

#### Classification & Measurement
- Vanilla instruments should meet SPPI test
- Consider business model
  - hold to collect contractual cash flows,
  - hold to sell or
  - both
- Loans and advances will generally be classified at amortised cost

#### Hedge Accounting
- Policy choice - remain on IAS 39, transition onto IFRS 9 or hybrid

#### Disclosures
- More granular credit risk, impairment and hedge accounting disclosures
**Investment Banking**

**Impairment**
- Implementation of new expected credit loss model
- Impairment for off statement of financial position items (loan commitments, financial guarantee contracts)

**Classification & Measurement**
- Vanilla instruments should meet SPPI test
- Instruments with leveraged returns would not meet the SPPI test (would be classified at FVTPL)
- Consider business model
  - hold to collect contractual cash flows,
  - hold to sell or
  - both
- Liquidity portfolios need to be assessed (FVOCI for mixed business model)
- Equity instruments (not held for trading) can be voluntarily designated at FVOCI- gains and losses will not be recycled into P&L
- Embedded derivatives in financial asset host contracts may no longer be separated

**Hedge Accounting**
- Policy choice - remain on IAS 39, transition onto IFRS 9 or hybrid

**Disclosures**
- More granular credit risk, impairment and hedge accounting disclosures

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**Asset Management**

**Impairment**
- Most financial assets are measured at fair value and not in scope for impairment

**Classification & Measurement**
- Most financial assets will continue to be measured at FVTPL

**Hedge Accounting**
- Not many asset managers apply hedge accounting

**Disclosures**
- Due to the impact on hedge accounting and impairment being assessed as low, the additional disclosures related to these sections would not be expected to have a significant impact
Insurance

Impairment
- To the extent that an insurer has insignificant assets measured at amortised cost, the impact of the new ECL requirements will be less
- The ECL requirements applies to FVOCI debt instruments. This represents a change from the accounting of AFS debt instruments under IAS 39

Classification & Measurement
- Vanilla instruments should meet SPPI test (would be classified at FVTPL)
- Instruments with leveraged returns would not meet the SPPI test
- Consider business model - hold to collect contractual cash flows, hold to sell or both
- Liquidity portfolios need to be assessed (FVOCI for mixed business model)

Hedge Accounting
- Insurers would consider (if they previously applied hedge accounting whether they will remain on IAS 39, transition onto IFRS 9 or use a hybrid

Disclosures
- More granular credit risk and impairment disclosures
Impact of adoption of IFRS 9 for non-financial institutions

Range of impact (depending on the instruments held)

<table>
<thead>
<tr>
<th>Impairment</th>
<th>Classification &amp; Measurement</th>
<th>Hedge Accounting</th>
<th>Disclosures</th>
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<tbody>
<tr>
<td>• All trade receivables will be subject to the new expected credit loss model</td>
<td>• Most vanilla amortised cost instruments (trade receivables, cash and cash equivalents) will remain as such (provided business model is to hold to collect contractual cash flows and SPPI test met)</td>
<td>• If no hedge accounting is applied, or the entity elects to remain on IAS 39 hedge accounting there will be minimal impact</td>
<td>• More granular credit risk disclosures</td>
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<tr>
<td>• Long term receivables (such as intercompany loans) will be subject to the general approach</td>
<td>• Certain equity instruments may be classified as FVTPL (if the FVOCI option is not elected)</td>
<td>• If an entity chooses to use the new IFRS 9 hedge accounting principles, there will be more strategies that qualify for hedge accounting.</td>
<td>• More granular credit risk, impairment and hedge accounting disclosures</td>
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<td>• Impairment for off statement of financial position items (loan commitments, financial guarantee contracts)</td>
<td>• If the FVOCI option is elected, there will be no recycling of gains/losses into profit/loss</td>
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<td>• FVOCI debt instruments (held for liquidity purposes) will be subject to new ECL model</td>
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<td>• Equity FVOCI instruments have no impairment in P&amp;L</td>
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## Financial Statement Impact of IFRS 9

### Banks and other financial institutions

#### Classification and measurement

Statement of financial position impact

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<th>Assets</th>
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<td>Cash and cash equivalents</td>
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## Non-financial institutions

### Classification and measurement

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## Impairment

Statement of financial position impact

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<td>Property, plant and equipment</td>
<td>xxx</td>
</tr>
<tr>
<td>Available for sale equity investments</td>
<td>xxx</td>
</tr>
<tr>
<td>Available for sale debt investments</td>
<td>xxx</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>xxx</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>xxx</td>
</tr>
<tr>
<td>Inventory</td>
<td>xxx</td>
</tr>
<tr>
<td>Trade &amp; other receivables</td>
<td>xxx</td>
</tr>
<tr>
<td>Derivative assets</td>
<td>xxx</td>
</tr>
</tbody>
</table>

**Total assets**

<table>
<thead>
<tr>
<th>R's</th>
</tr>
</thead>
<tbody>
<tr>
<td>xxx</td>
</tr>
</tbody>
</table>

### Liabilities

<table>
<thead>
<tr>
<th>Type</th>
<th>R's</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-current liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Finance lease liabilities</td>
<td>xxx</td>
</tr>
<tr>
<td>Deferred tax liabilities</td>
<td>xxx</td>
</tr>
<tr>
<td>Long-term loans</td>
<td>xxx</td>
</tr>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Short term portion of long-term loans</td>
<td>xxx</td>
</tr>
<tr>
<td>Trade &amp; other payables</td>
<td>xxx</td>
</tr>
<tr>
<td>Finance lease liabilities</td>
<td>xxx</td>
</tr>
<tr>
<td>Provisions</td>
<td>xxx</td>
</tr>
<tr>
<td>Current tax liabilities</td>
<td>xxx</td>
</tr>
</tbody>
</table>

**Total liabilities**

<table>
<thead>
<tr>
<th>R's</th>
</tr>
</thead>
<tbody>
<tr>
<td>xxx</td>
</tr>
</tbody>
</table>
Questions that audit committees should be asking:

1. How far is my organisation in terms of its IFRS 9 implementation plan?
2. Does the organisation have the necessary data and systems in place in order to calculate expected credit losses?
3. In determining the new classification of financial assets, what controls need to be put in place to govern the processes around determining the business model of the entity for different portfolios of assets?
4. How will forward looking information be incorporated in the expected credit loss impairment calculation?
5. How will the impact of IFRS 9 be communicated with shareholders?
IFRS 9 implementation timeline

Preparing for IFRS 9 implementation presents a considerable challenge. Many financial institutions have already at this stage developed implementation plans and are in the process of designing, building and testing impairment models. Non-financial institutions should not underestimate the impact that this new standard will have and should be performing the necessary impact assessments and developing the plan for implementation.

Once a diagnostic has been performed and the current state has been assessed, the following timeline will need to be considered.

<table>
<thead>
<tr>
<th>Year</th>
<th>Design</th>
<th>Build</th>
<th>Test</th>
<th>Deploy</th>
<th>Parallel run</th>
<th>First reporting period under IFRS 9</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

With IFRS 9 being effective for annual periods beginning on or after 1 January 2018, entities need to be setting out work plans with clear timelines. There is less than a year left for entities to design, build and test their IFRS 9 solutions. Many financial institutions will be aiming to deploy and run on parallel their new IFRS 9 solutions in 2017.

We have identified the following critical success factors:

1. Establish project structure and governance
2. Ensure collaboration between risk and finance
3. Assess impact on financial position, performance and policies
4. Establish data and system requirements
5. Educate key stakeholders
How can EY help you?

IFRS 9 represents a significant change to the accounting for financial instruments. The implementation date is fast approaching leaving little remaining time for clients to prepare.

How can we help?
1. Performing a gap analysis
2. Assessing the financial impact
3. Assisting with your IFRS 9 roadmap & programme governance
4. Training and workshops
5. Detailed implementation support including:
   ▪ Impairment model build
   ▪ Data/systems and controls impact assessment
   ▪ Reporting and disclosures

We have a number of tools to assist you to plan, design a solution and implement the changes. This project can be combined with other IFRS implementations such as IFRS 15 - Revenue from Contracts with Customers and IFRS 16 - Leases.

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