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Contains disclosure in interim and annual financial statements

Not only for banks – Discover IFRS 9 in the world of corporates

Case study

[Excerpt from publication]

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Introduction

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IFRS 9 "Financial Instruments", developed over many years, is now becoming reality. The standard is effective from financial years beginning 1 January 2018 or later. The new standard will severely impact financial institutions, as they commonly have material and complex portfolios of financial instruments and sophisticated financial risk management models. However, IFRS 9 will also affect non-financial services entities, even if they only have simple financial instruments, such as trade or loan receivables.

This publication illustrates the process of IFRS 9 implementation for a hypothetical company from the non-financial services sector. It does not show all the possible adjustments resulting from the implementation of IFRS 9, but only those we consider to be the most common.

To calculate some of the adjustments, PwC has developed a tool, "myIFRS9". Its application is described briefly in the case study.

The process of the new standard implementation might be broken down into the following phases:

Phase 0	Phase 1	Phase 2	Phase 3	Phase 4	Phase 5
Project organisation and initial training	Initial impact analysis	Calculating adjustments as at 1/1/2018	Preparing disclosures in the 2017 financial statements	Adjusting accounting records, amending systems and procedures	Drafting disclosures and 2018 financial statements

This case study contains a short overview of the Company followed by a summary of the work conducted at Phase 1 and 2. We conclude our publication with an example of a disclosure note that is required to be included in the financial statements for the year ended 31 December 2017 (in accordance with the requirements of IAS 8 and guidelines issued by ESMA) followed by the disclosure in the interim and annual financial statements in 2018, when IFRS 9 will be applied for the first time. This publication is not a comprehensive source of knowledge on IFRS 9 - it is intended to serve as a practical illustration of how to implement IFRS 9 in a non-financial services entity and how to effectively communicate its effects.

We hope that this case study will help you to understand the process of IFRS 9 implementation and its impact on your organisation.

Overview of the Company

and Phase 1 Initial impact analysis

Commentary

In this section, we describe the results of an initial IFRS 9 impact analysis on the Company. Before the summary of the initial impact analysis we have provided key facts about the Company and the financial instruments it holds. The impact analysis, which typically takes from a few days to a few weeks, enables the key decision-makers in the Company to understand the potential areas of adjustments, determine the scope of necessary work and reduces the risk of additional adjustments arising at subsequent stages.

Paweł Wesołowski
Partner

Overview of the Company

The Company prepares its financial statements in accordance with EU IFRS and operates in the production and services sector. The Company has only simple financial instruments, no derivatives and does not apply hedge accounting as at 31/12/2017. An extract from its financial statements as at the last balance sheet date prior to the first application of IFRS 9 is presented below:

31/12/2017	*(in EUR '000)*		*Information about financial instruments*
Trade receivables			The receivables consist of amounts from individual and corporate customers. The Company is highly effective in collecting its receivables. It recognizes a 50% impairment loss allowance for amounts overdue by more than 90 days. As at 31 December 2017, the impairment loss allowance amounted to EUR 800 thousand. In addition, receivables with a gross carrying amount of EUR 750 thousand were provided by a 100% impairment loss allowance. Some receivables are subject to factoring arrangements.
Gross carrying amount	25,850		
Loss allowance	(1,550)	24,300	
Loans granted			The Company granted three loans to other entities. These loans are measured at amortized cost. Since these loans have been serviced without delay the Company has not recognized any impairment loss allowance.
Gross carrying amount	5,000		
Loss allowance	-	5,000	
Cash	800	800	Cash is held at banks with high creditworthiness (i.e. a high credit rating).
Interest in other entities	7,000		Minority interest (12%) in unquoted Company Y. Under IAS 39 they are classified as available for sale and measured at cost less impairment in accordance with IAS 39.46c, (no impairment has been identified).
Loss allowance	-	7,000	
Total financial assets		37,100	
Other (fixed assets, inventories)		28,000	
Assets		**65,100**	
Bank borrowings		37,650	Long-term loan received in 2010. Towards the end of 2017, the Company renegotiated the terms of the loan (financing period and interest rate). The changes did not result in the derecognition of the original liability and recognition of a new liability. The impact of the additional costs (additional commission and a higher interest rate) of EUR 850 thousand was reflected by modifying the effective interest rate of the loan.
Trade payables		9,000	Trade payables towards suppliers, not overdue.
Total financial liabilities		46,650	
Equity (including retained earnings: 6,000)		18,450	
Equity and liabilities		**65,100**	

Materiality level applied for adjustments to financial statements

The Company assumes that a total change in equity/net profit of EUR 200 would be of material importance to investors and, therefore, it determined that adjustments identified in respect of individual balance sheet items in excess of EUR 20 thousand (i.e. 10% of the overall materiality level) are always recognized in the financial statements.

Phase 1 – Initial impact analysis

In September 2017, the Company conducted an initial analysis of the impact of IFRS 9 application. The purpose of the intial analysis was to identify those areas subject to possible IFRS 9 adjustments. Those areas would then be subject to further analysis together with determination of actual adjustments under Phase 2. The Phase 1 findings are summarised in the following table (the references to Phase 2 contain further details about the issue, the final conclusion and calculation of the adjustment as at the date of the transition to IFRS 9 i.e. 1 January 2018).

Area and potential impact of IFRS 9	*See further*
Trade receivables: (1) Receivables from Customer X are rthe subject of factoring arrangements with a Bank. These receivables will need to be measured at fair value, (2) For other receivables impairment loss allowances are to be determined in accordance with the IFRS 9 expected credit losses model instead of the incurred credit loss model currently applied. It is suggested that the Company applies the simplified approach permitted by IFRS 9 (the use of a provision matrix based on historical data adjusted for forward looking information) – separate matrices should be developed for corporate and individual customers as they have different risk profiles.	**Phase 2.1**
Loans granted: (1) The need to perform and document SPPI classification tests/benchmark tests, due to the fact that loans carry variable interest rates but the frequency of reset of the interest rate does not match the tenor of the interest rate. If a test is failed, fair value measurement will be necessary, (2) For loans that continue to be measured at amortized cost, it is necessary to determine their qualification to Stage 1/Stage 2 of the expected credit losses model and calculate the loss allowance accordingly. It is suggested that calculations are performed separately for each exposure based on an individually determined credit score/rating.	**Phase 2.2**
Interest in other entities: (1) The need to assess whether cost represents the fair value, and if not – to estimate the potential difference and, depending on its expected amount, determine whether a valuation by an external expert is necessary, (2) Determining whether the Company intends to recognize fair value changes in profit or loss or in other comprehensive income.	**Phase 2.3**
Cash: The balances meet the criteria to be measured at amortized cost therefore it is necessary to estimate the impact of any impairment loss allowance in accordance with the expected credit losses model. It is suggested that the calculations should be based on published external ratings of the relevant banks.	**Phase 2.4**
Bank loans: It was determined that it is necessary to re-calculate amortized cost using the original effective interest rate determined on receipt of the loan in 2013 and not the effective interest rate determined following the 2017 modifications.	**Phase 2.5**
Trade payables: No potential differences compared with the current accounting treatment were identified.	
Other areas: No other IFRS 9 adjustments were identified.[1] However, due to the issues identified above, it will be necessary to change accounting policies, modify accounting systems and procedures and prepare new disclosures (including in the financial statements as at 31/12/2017), and to calculate tax effects on the adjustments identified.	

[1] Please note that there may be other areas requiring IFRS 9 adjustments (e.g. hedge accounting, embedded derivatives, loss allowance for finance lease receivables, etc.). These do not apply in this case study but may apply for other companies.

If you found this publication of interest and would like to find out:

- *how the Company continued the analysis and determined adjustments affecting assets, liabilities and equity balances as at the date of the transition to IFRS 9 i.e. 1 January 2018;*
- *how to calculate such adjustments in detail (eg. calculate expected credit losses, determine fair value or conduct an SPPI test) using existing simple tools or how to develop such tools yourself;*
- *how to prepare information (to be included in the financial statements as at 31 December 2017) on the impact of IFRS 9 in accordance with the requirements of IAS 8 and guidelines issued by ESMA (and how such an illustrative note looks like),*
- *how to prepare interim and annual financial statements in 2018, when IFRS 9 is applied for the first time,*

please do not hesitate to contact us – we will be pleased to provide you with the electronic version of the entire case study free of charge.

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If you would like to attend a workshop where this case study is discussed step by step, or have such a workshop organized and delivered by us inhouse in your own company, please contact:

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myIFRS9 is a set of simple to use tools that support financial instruments accounting

Choose for yourself what you need myIFRS9 for:

SPPI classification module

A module with a SPPI test form

- Enables classification of a given financial instrument in line with SPPI requirements
- Indicates further steps in determination of the valuation method

Individual exposure loss allowance module

A module for estimating an expected credit losses

- Enables analysis of the borrower's credit risk – at the moment of loan recognition and at the balance sheet date
- Allows a loan to be classified to Stage 1, Stage 2 or Stage 3 and calculates the impairment loss for Stage 1 and 2 exposures

Fair value of debt instruments module

A module for estimating fair value

- Estimates the borrower's rating based on financial data and then calculates the market discount rate that is used to discount the expected cash flows

Portfolio loss allowance module

A module for estimating the expected credit loss

- Enables calculation of expected loss allowance for a given group of receivables based on the history payments of invoices

Equity investments assessment module

A module for assessing the materiality of the difference between the cost and fair value for minority interests

- Performs multiples analysis based on industry indicators
- Determines whether the difference between the cost and fair value is significant – and whether a further professional valuation may be needed

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From the authors

Thank you for taking an interest in our publication. We encourage you to read the full version. We would be grateful for any comments or suggestions – please send them to us by email.

We thank our PwC colleagues, who deal with IFRS 9 application issues or related training on a daily basis, and assisted us in the preparation of the case study – their photographs and contact details are inserted at various places in this publication and also below.

We have finalized working with our hypothetical company – the last key challenge was the preparation of a complete set of annual financial statements taking into account the requirements of IFRS 9. We share the results of our work with you illustrating how a "normal" Company can present information about financial instruments in a manner that is both accessible to readers and tailored to its activities.

Publications and PwC resources relating to IFRS, which may be useful in the preparation of financial statements

IFRS Illustrative consolidated financial statements

IFRS 9, Financial Instruments. Understanding the basics

Inform - online resource. Authoritative literature for IFRS and PwC's guidance

Our team dealing with implementation of IFRS 9

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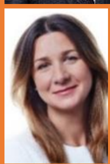
myIFRS9 Tools



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Training- open and in company workshops

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