IFRS 9
FINANCIAL INSTRUMENTS

CPA WILFRED OWALLA

Why the New Standard?

IFRS 9 responds to criticisms that IAS 39 is too complex, inconsistent with the way entities manage their businesses and risks, and defers the recognition of credit losses on loans and receivables until too late in the credit cycle.

CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS

MAJOR CHANGES

IAS 39 Categories	IFRS 9 Categories
Held to maturity investments	Amortized cost
Loans and receivables	FVOCI
FVTPL	FVTPL
Available-for-sale financial assets	

MAJOR CHANGES

Classification Basis

Under IAS 39, classification of financial assets is mostly based on specific definitions for each category which then determines the measurement.

Under IFRS 9, classification categories are aligned with the measurement which enhances simplicity.

Classification of financial assets is also more principle based and depends on two assessments:

Entity's business model for managing the financial asset. ('Business Model Test');

Financial asset's contractual cash flow characteristics.

'(Cash Flow Characteristics Test').

Business Model

IFRS 9 uses the term in relation to how financial assets are managed and extent to which cash flows will result from collecting contractual cash flows, selling financial assets or both

Two business models are positively defined:

- **a 'hold to collect' business model**
- **a 'hold to collect and sell' business model**

Debt-type financial assets that are not managed under either of these models will need to be measured at fair value through profit or loss

Determining the Business Model

An entity's business model refers to how an entity manages its financial assets in order to generate cash flows.

Business Model is determined by

- entity's key management personnel.
- how performance is evaluated and reported to entity's key management personnel
- risks affecting performance of business model and how those risks are managed
- how managers of business are compensated (eg whether compensation is based on fair value of assets managed or on contractual cash flows collected).

Level of Determination

An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective.

Accordingly, assessment does not depend on management's intentions for individual instruments.

Also, for IFRS 9 purposes, an entity can have more than one business model.

example

An entity holding a portfolio of mortgage loans may manage some of the loans to collect contractual cash flows while having an objective of selling other loans within the portfolio in the near term.

The portfolio would be sub-divided, with part of it being accounted for under a hold to collect business model while the other loans are accounted for at fair value through profit or loss.

Hold to collect business model

A ‘hold to collect’ business model is one in which assets are managed to realize cash flows by collecting contractual payments over the instruments’ lives.

In determining whether cash flows are going to be realized by collecting the financial assets’ contractual payments, it is necessary to consider:

- frequency, value and timing of sales in prior periods
- reasons for those sales and
- expectations about future sales activity.

Objective

- collect contractual payments over life of the instrument
- entity manages the assets held within the portfolio to collect **those particular** contractual cash flows

Hold to collect and sell business model

Key management personnel decide that both collecting contractual cash flows and selling financial assets are integral to achieving the objective of the business model.

Entities will need to exercise an element of judgement because there is no threshold for frequency or value of sales that must occur in this business model.

However, this business model will typically involve greater frequency and value of sales than a hold to collect model **selling financial assets is integral** to achieving business model's objective instead of being only incidental to it.

Other business models

If a debt-type financial asset is not held within either a hold to collect business model or a hold to collect and sell business model, then it will be measured at fair value through profit or loss.

IFRS 9 gives a number of examples of models which will result in fair value through profit or loss measurement, including business models in which:

- entity manages financial assets with the objective of realizing cash flows through the sale of the assets
- entity manages and evaluates a portfolio of financial assets on a fair value basis
- a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows or held both to collect contractual cash flows and to sell financial assets.

Model	Possible examples
Hold to collect contractual cash flows	• trade receivables • originated loans and debt securities held to maturity
Hold to collect contractual cash flows and to sell	• liquidity portfolio • assets held by an insurer to back insurance liabilities
Other (not defined	• trading portfolios • assets managed on a fair value basis

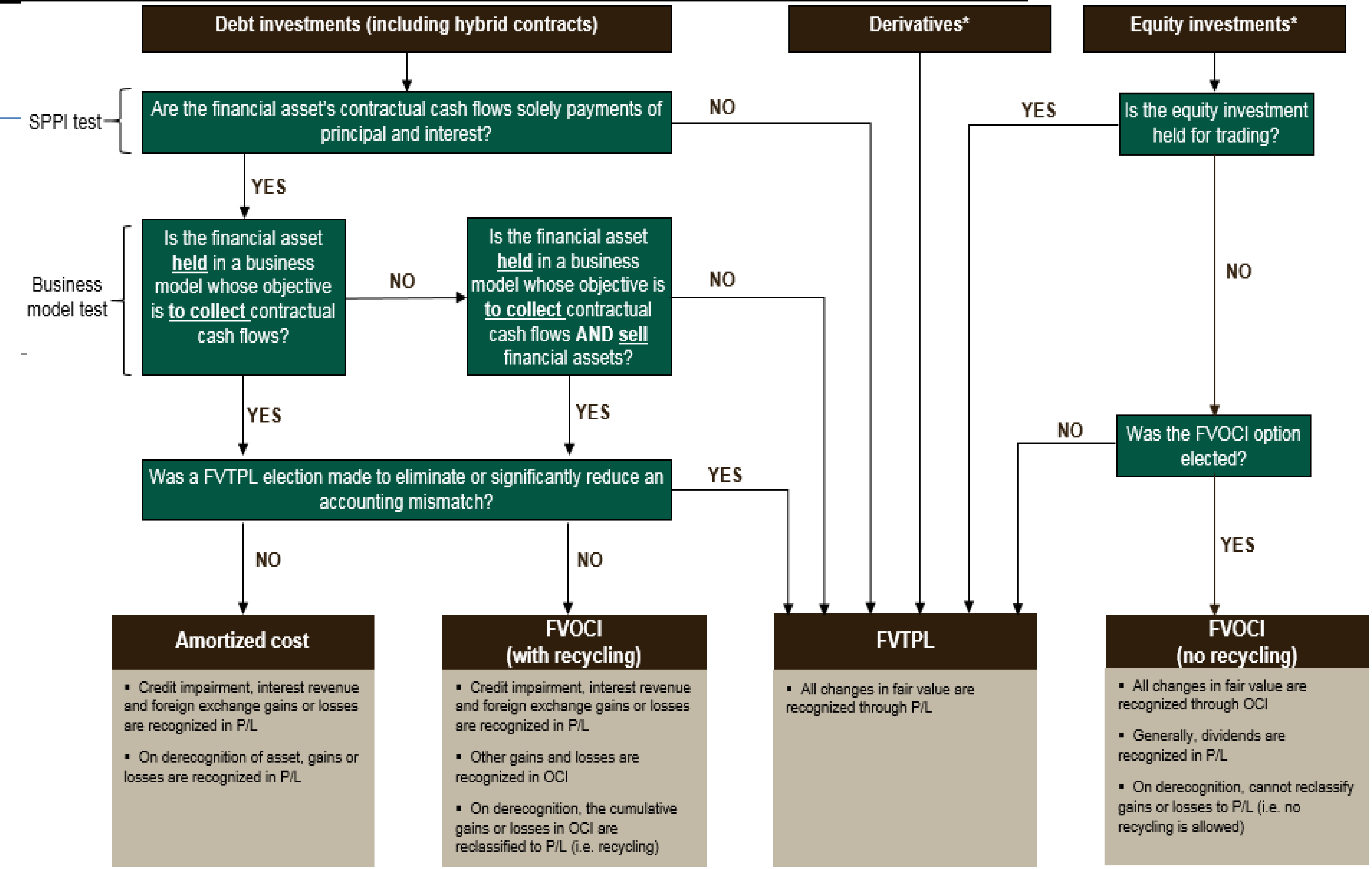
Contractual cash flows characteristics test

The contractual cash flow characteristics test is the second of the two tests that determine the classification of a financial asset.
For the test to be met, the contractual terms of the financial asset must give rise on specified dates to cash flows that are solely payments of principal and interest.
It is only possible to classify a financial asset in the amortised cost or fair value through other comprehensive income category where the test is met.

SPPI INTEREST TEST

Principal	**Interest**
For the purpose of applying this test, 'principal' is the fair value of the financial asset at initial recognition. The Standard acknowledges however that the principal amount may change over the life of the financial asset, for example as a result of repayments of principal	'Interest' consists of consideration for: • the time value of money • the credit risk associated with the principal amount outstanding during a particular period of time • other basic lending risks and costs • a profit margin.

Classification Decision Tree



Categories	Conditions to be Met	Impact
Amortized Cost	• Financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows ("Business Model test"). • The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding ("SPPI contractual cash flow characteristics test"). (IFRS 9.4.1.2)	• Investments classified as held to maturity under IAS 39 and measured at amortized cost will likely fall into this category. • This category will also contain other debt investments, which are classified as loans and receivables under IAS 39, if it meets the SPPI contractual cash flow characteristics and business model test.

Categories	Conditions to be Met	Impact
FVOCI	▪ Financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets (*"business model test"*). ▪ Contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (*"SPPI" contractual cash flow characteristics test"*). ▪ Entity may, at initial recognition, make an irrevocable election to present in OCI subsequent changes in the fair value of an investment in an equity instrument within the scope of IFRS 9 *(IFRS 9.4.1.2A & IFRS 9.5.7.5-6*	Although debt investments and equity investments that are designated at FVOCI could fall into this category, the measurement for such debt and equity investments are different as demonstrated in the decision tree above.

Categories	Conditions to be Met	Impact
FVTPL	• A financial asset shall be measured at FVTPL unless it is measured at amortized cost or at FVOCI. • An entity may, at initial recognition, irrevocably designate a financial asset as measured at FVTPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency (“accounting mismatch”) that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases.	Derivatives and held for trading investments will fall into this category as under IAS 39. In addition, some loans and receivables and equity investments (which under IAS 39 are measured at amortized cost or classified as available-for-sale and carried at cost or FVOCI respectively), may also fall into this category. • IAS 39 contains two other instances where a FVTPL designation can be made. These designations disappear under IFRS 9 because of the new classification model and further simplifies the financial instrument accounting requirements. • The available-for-sale category under

Investments in Private Entities Measured at Cost Under IAS 39

IAS 39 allows certain equity investments to be measured at cost. Specifically, when:

- There is no quoted market price in an active market; and
- Fair value cannot be reliably measured because either:
- Variability in the range of reasonable fair value estimates is significant;
- Probabilities of the various estimates within the range cannot be reasonably assessed and used in estimating fair value.

IFRS 9 requires that all investments in equity instruments be measured at fair value.

IFRS 9 mentions that in limited circumstances cost may approximate fair value, for example, when:

- Insufficient more recent information is available to measure fair value; or
- There is a wide range of possible fair value measurements and cost represents the best estimate of fair value in the range.

Classification and Measurement of Financial Liabilities

IFRS 9 requirements for the classification and measurement of financial liabilities are substantially unchanged from IAS 39 except for the following:

- Removal of the cost exception for derivative financial liabilities.
- Changes in fair value as a result of an entity's own credit risk are recognized in OCI.

Overall, financial liabilities are still measured at amortized cost except for:

- Financial liabilities measured at FVTPL (i.e., those held for trading, designated at FVTPL or contingent consideration recognized by an acquirer in a business combination).
- Loan commitments and financial guarantee contracts for which specific measurement guidance exists.

Impairment

Accounting for impairments is the second major area of fundamental change:

• **Investments in equity instruments.** On the one hand, IFRS 9 eliminates impairment assessment requirements for investments in equity instruments because, as indicated above, they now can only be measured at FVPL or FVOCI without recycling of fair value changes to profit and loss.

• **Loans and receivables, including short-term trade receivables.** On the other hand, IFRS 9 establishes a new approach for loans and receivables, including trade receivables—an "expected loss" model that focuses on the risk that a loan will default rather than whether a loss has been incurred.

Impairment

IAS 39 Incurred Loss Model	IFRS 9 Expected Credit Loss Model
▪ Delays recognition of credit losses until there is objective evidence of impairment. ▪ Only past events and current conditions are considered when determining the amount of impairment (i.e., the effects of future credit loss events cannot be considered, even when they are expected).	▪ Expected credit losses (ECLs) are recognized at each reporting period, even if no actual loss events have taken place. ▪ In addition to past events and current conditions, reasonable and supportable forward-looking information that is available without undue cost or effort is considered in determining impairment.
• Different impairment models for different financial instruments subject to impairment testing, including equity investments classified as available-for-sale.	▪ The model will be applied to all financial instruments subject to impairment testing.

Expected credit losses

Under the "expected credit loss" model, an entity calculates the allowance for credit losses by considering on a discounted basis the cash shortfalls it would incur in various default scenarios for prescribed future periods and multiplying the shortfalls by the probability of each scenario occurring.

IFRS 9 three separate approaches for measuring and recognizing expected credit losses:

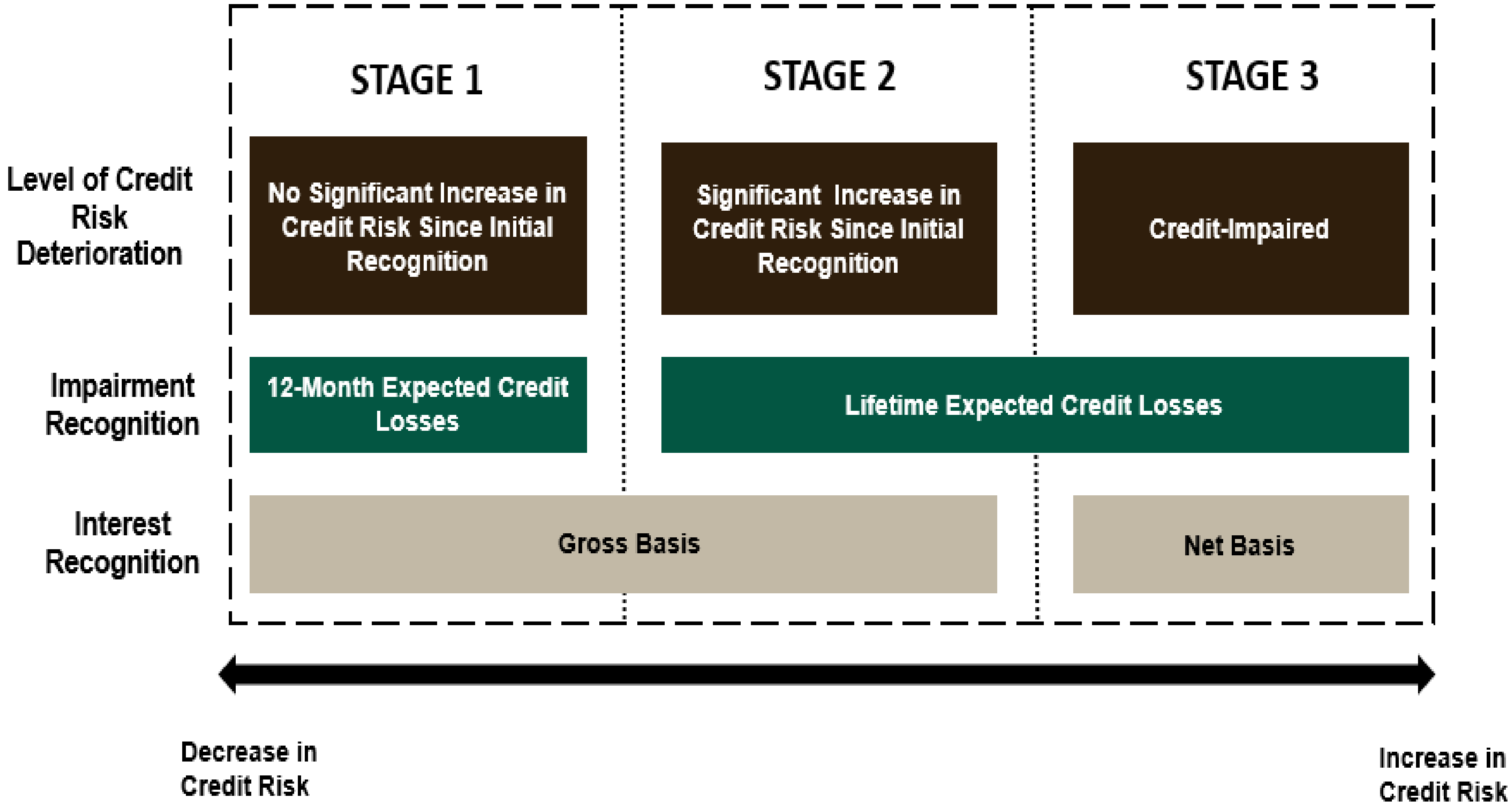
- A general approach that applies to all loans and receivables not eligible for the other approaches;
- A simplified approach that is required for certain trade receivables and so-called "IFRS 15 contract assets" and otherwise optional for these assets and lease receivables.
- A "credit adjusted approach" that applies to loans that are credit impaired at initial recognition (e.g., loans acquired at a deep discount due to their credit risk).

Expected credit losses

A distinguishing factor among the approaches is whether the allowance for expected credit losses at any balance sheet date is calculated by considering possible defaults only for the next 12 months (“12 month ECLs”), or for the entire remaining life of the asset (“Lifetime ECLs”). For those entities which have only short-term receivables less than a year in duration, the simplified and general approach would likely have little practical difference.

In all cases, the allowance and any changes to it are recognized by recognizing impairment gains and losses in profit and loss.

Overview of Impairment Requirements Under the New IFRS 9 Expected Loss Model



ICPAK

Uphold Public Interest

ICPAK
Uphold Public Interest

ICPAK

Uphold Public Interest

ICPAK
Uphold Public Interest