Webinar

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IFRS 9 Financial Instruments: Recognition and Measurement

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Background

Financial Instruments are simply a means of borrowing and lending. Their accounting treatment and presentation has been somewhat controversial, and IASB has made substantial effort to improve consistency in their accounting treatment, presentation and disclosures, by lenders and borrowers.

Background

IASB began with IAS 32 on presentation of financial instruments by borrowers, then developed IAS 39 on recognition and measurement. Later IASB developed IFRS 7 on disclosures, then began developing IFRS 9 to replace IAS 39 which was done in phases until 2018 when IFRS 9 replaced IAS 39 fully.

Content

		Lenders	Borrowers
1	Definitions (IAS 32 –For borrowers and IFRS 9)	√	√
2	Recognition (IFRS 9, see IAS 32 for additional guidance on equity/ Financial liabilities by borrowers)	√	√
3	Classifications (IFRS 9)	√	√
4	Initial Measurement (IFRS 9)	√	√
5	Subsequent Measurement (IFRS 9)	√	√
6	Reclassifications (IFRS 9)	√	N/A
7	De-recognition (IFRS 9)	√	√
8	Impairment of Financial Assets (IFRS 9)	√	N/A
9	Hedging (IFRS 9)	√	√
10	Embedded Derivatives (IFRS 9)	√	√
11	Disclosures (See IFRS 7)	√	√

Definitions

A **Financial Instrument** is any **contract** that gives rise to

- a **financial asset** of one entity; and
- a **financial liability or equity instrument** of another entity.

A Financial Asset is any asset that is:

- cash **e.g.** cash in hand or at bank
- an equity instrument of another entity **e.g.** investment in shares or share options.
- a contractual right to receive cash (or another financial asset) **e.g.** trade receivables, loans and Investments in bonds.
- a contractual right to exchange financial instruments under conditions that are potentially favorable **e.g.** Derivatives that have a positive payoff.
- a non-derivative contract for which the entity is or may be obliged to **receive** a variable number of the entity's own equity instruments **e.g.** a contract with customer to receive our own shares/options (variable number or fixed amount).

Definitions

A **Financial Liability** is any liability that is:

- a contractual obligation to deliver cash (or another financial asset) **e.g.** Trade payables, loans borrowed, bonds issued and redeemable Preference shares.
- a contractual obligation to exchange financial instruments underconditions that are potentially unfavourable **e.g.** Derivatives that have a negative payoff.
- a non-derivative contract for which the entity is or may be obliged to **deliver** a variable number of the entity's own equity instruments **e.g.** a contract with supplier to deliver our own shares/options (variable number or fixed amount).

An Equity instrument is any **contract** that evidences a **residual interest** in the assets of an entityafter deducting all of its liabilities **e.g.** Ordinary shares, Preference Shares & share options issued by an entity.

Definitions

A **Derivative** is a financial instrument with all three of the following characteristics:

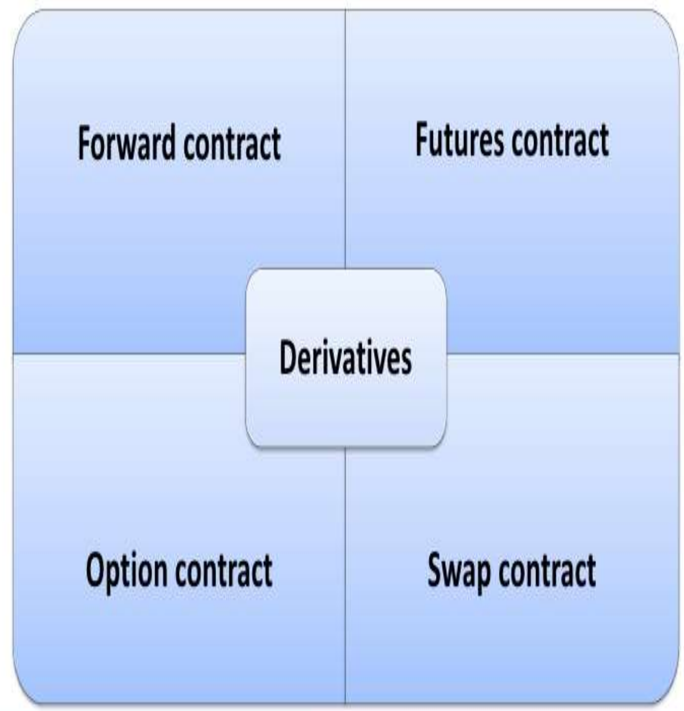
(a) **its value changes in response to the change in** a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or similar variable (called the '**underlying**');

(b) it requires **no or little initial net investment** relative to other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is **settled at a future date.**

e.g. options, forward contracts, future contracts, swap contracts etc.

Types of Derivatives



Recognition – Lender and Borrower

IFRS 9 requires both the lender and the borrower to recognise a financial instrument when the entity becomes party to the contractual provisions of the instrument.

For a lender, this is a financial asset and for a borrower this is either equity or a financial liability.

IAS 32 guides the borrower in four areas:

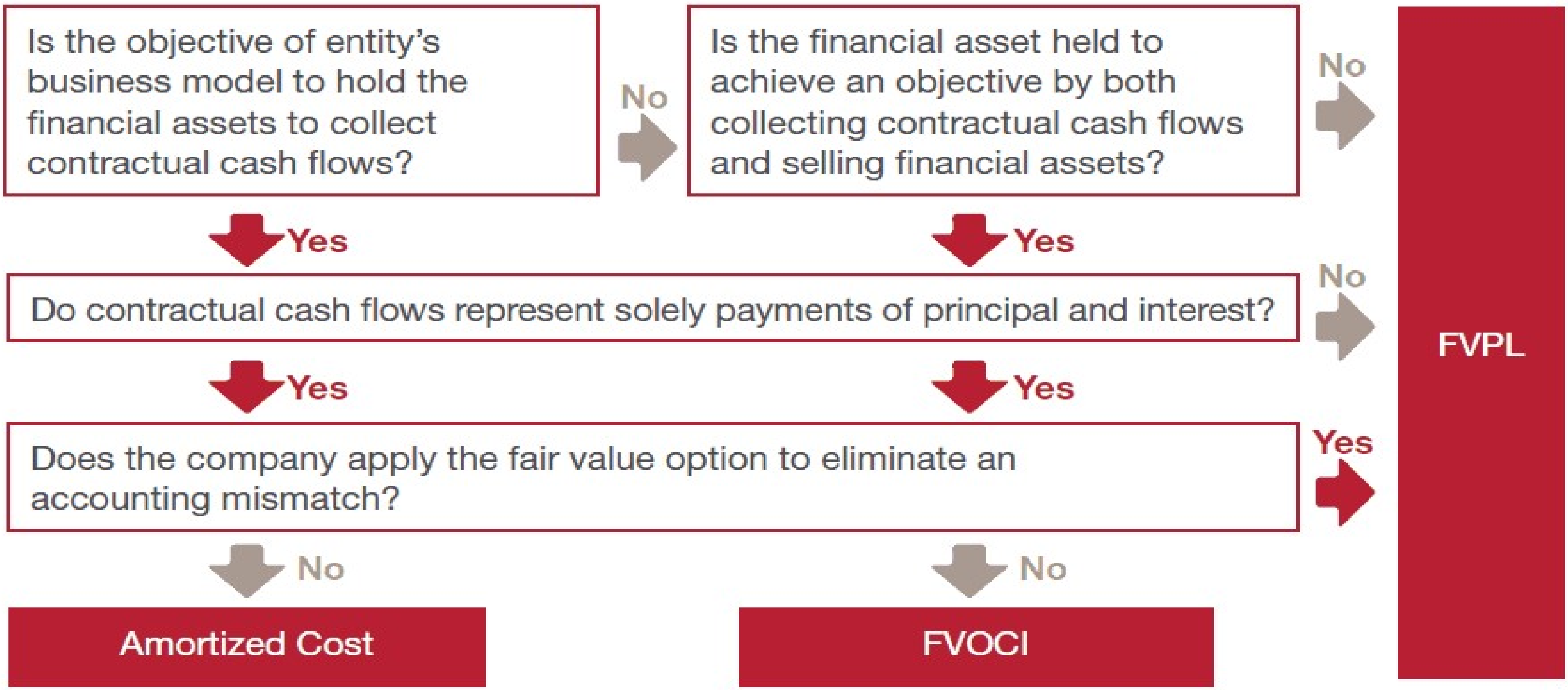
1.How to *distinguish equity* from *financial liabilities.*

2. *Compound financial instruments* i.e. a financial instrument having the characteristics of both equity and a financial liability.

3.Presenting *treasury shares* i.e. own shares that the entity has bought back.

4.Conditions when an entity can *offset* a financial asset and a financial liability in the financial statements.

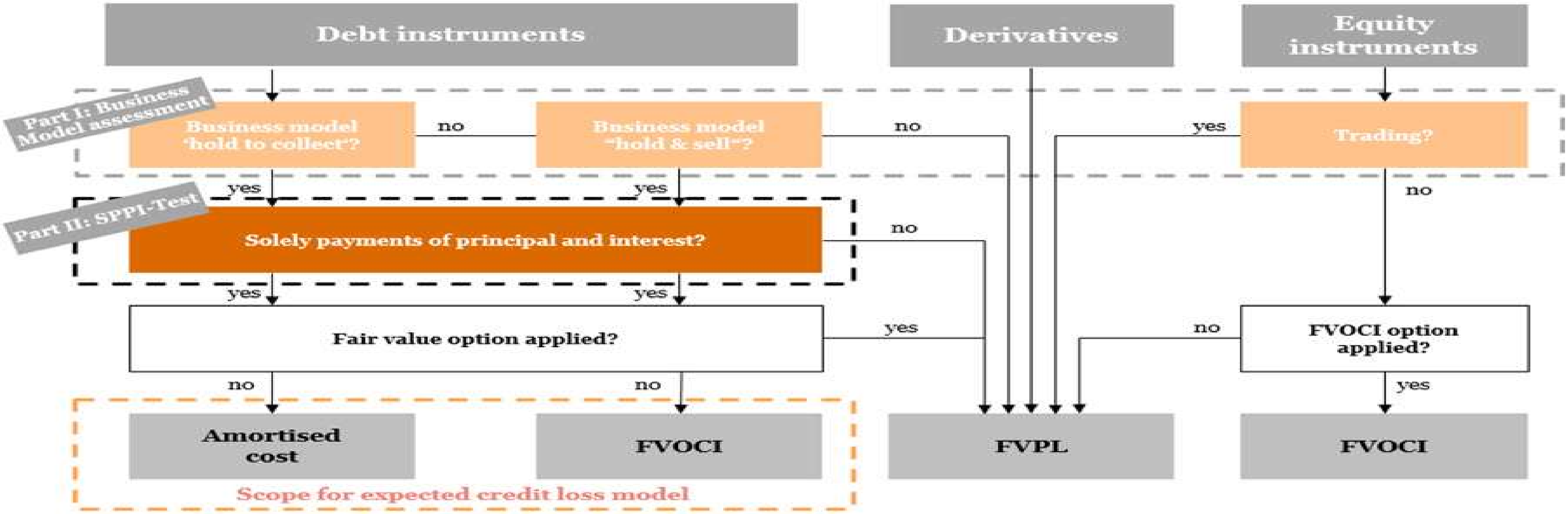
Classification of Financial Assets by the Lender



Classification of Financial Assets by Lender

IFRS 9 Classification & Measurement

3 steps to classify financial assets

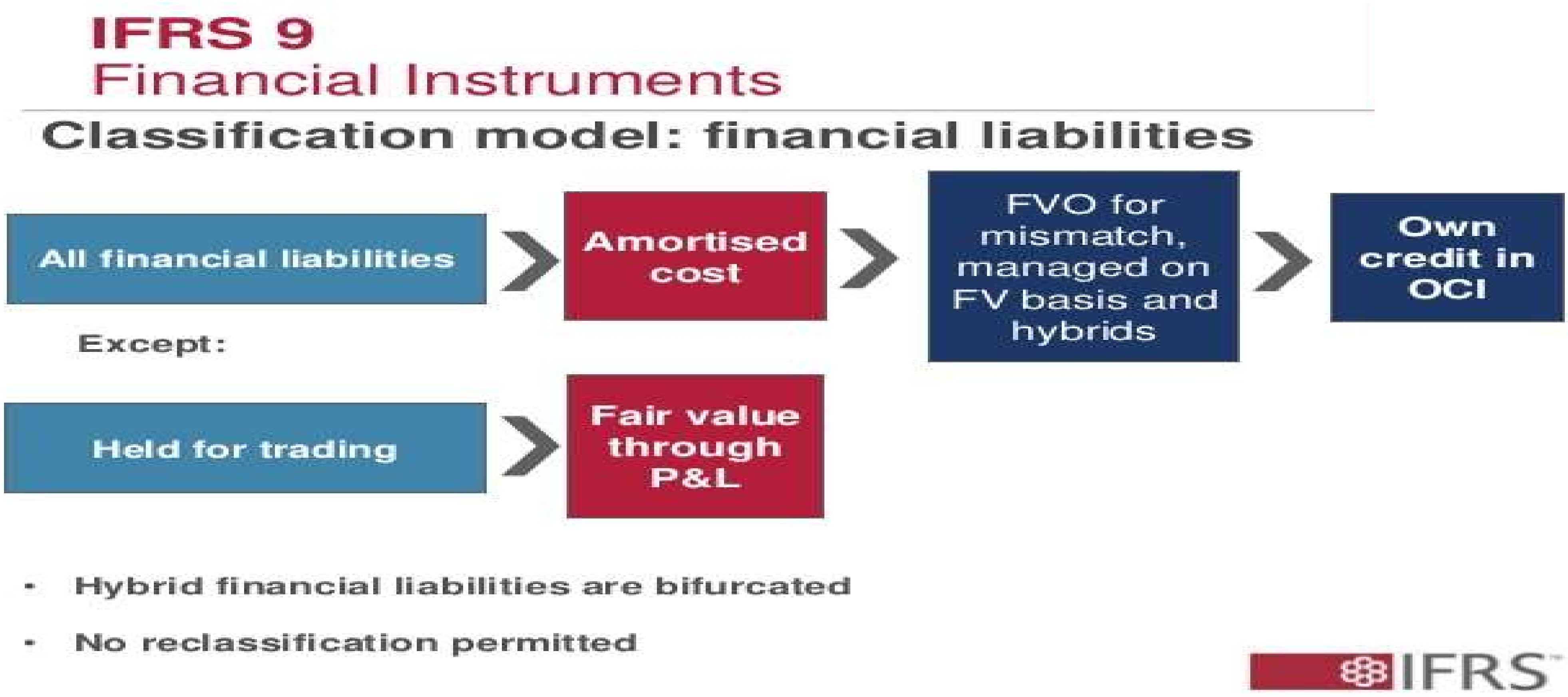


Caption: SPPI = Solely Payments of Principal & Interest
FVOCI = Fair Value through Other Comprehensive Income
FVPL = Fair Value through Profit & Loss

Classification of Financial Assets by Lender

How will a lender classify the following financial assets?	Answer
Investments held for trading purposes.	FVPL
Investment in ABC bond, not listed, maturing in five years. The intention is to collect cash flows (which are interest and principal amounts only)	AC
Investment in XYZ bond, listed, maturing in five years. The intention is to collect cash flows (which are interest and principal amounts only). However, the entity may sell the bond earlier if the price increases.	FVOCI
A trade receivable	AC
Derivatives held for speculation purpose, with a favorable position	FVPL
Investment in equity shares of a private company. The entity has no intention of sdlgthese shares in foreseeable future.	FVOCI
Investment in loan notes. The objective is to collect contractualcash flows which consist of interest, changes in oil prices in next five years and principal amount at the end of year 5.	AC
Investment in loan notes. The objective is to collect contractualcash flows which consist of interest, changes in oil prices in next five years and principal amount at the end of year 5. However, the entity may sell the loan notes earlier if any good offer is received.	FVOCI
Investment in convertible Loan Stock	AC

Classification of Financial Liabilities by the borrower



Classification of Financial Liabilities by the borrower - Examples

How will a borrower classify the following financial liabilities?	Answer
Borrowed a 12% bank loan from A Limited payable in 5 years'time.	AC
Issued a 5-year 8% loan stock trading in the market, but intention is to settle on maturity	AC
Entered into a short-term currency swaps agreement with Absa Bank Limited which is currently unfavorable.	FVPL
Trade payable	AC

Initial Measurement and Subsequent Measurement

Initial and Subsequent Measurement of Financial Assets			
Category	**Initial measurement**	**Subsequent measurement**	**Changes**
FVPL	Fair value	Fair value	Change in Fair Value > PoL
FVOCI (Equity)	Fair value + transaction costs	Fair value	Change in Fair Value > OCI
FVOCI (Debt)	Fair value + transaction costs	First, include effectiveinterest Secondly, Change to FV	Effective Interest > PoL Change in Fair Value > OCI
Amortized cost (AC)	Fair value+ transaction costs	Amortized cost	Effective Interest > PoL

Initial and Subsequent Measurement of Financial Liabilities			
Category	**Initial measurement**	**Subsequent measurement**	**Changes**
FVPL	Fair value	Fair value	Change in Fair Value > PoL
Amortized cost (AC)	Fair value - transaction costs	Amortized cost	Effective interest > PoL

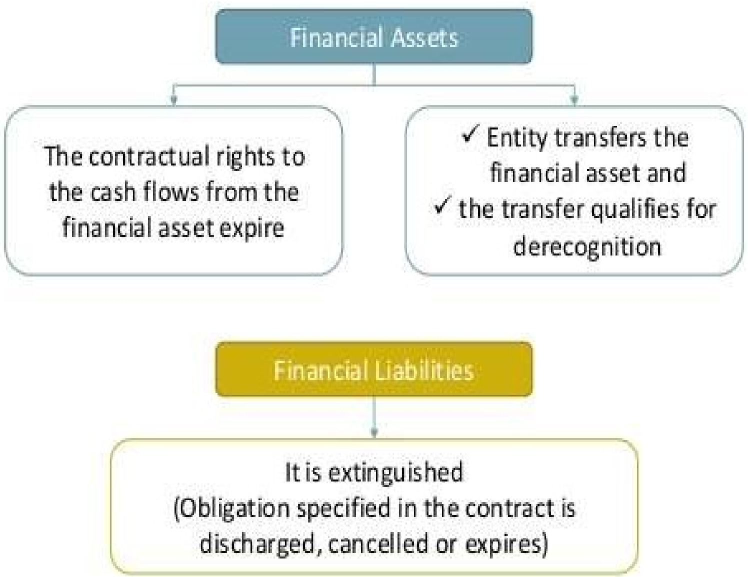
Reclassifying Financial Assets by the Lender

Accounting for asset reclassifications

From	To	Requirement
Amortized Cost	FVPL	Measure fair value at reclassification date and recognize difference between fair value and Amortized Cost in profit and loss
FVPL	Amortized Cost	Fair value at the reclassification date becomes the new gross carrying amount
Amortized Cost	FVOCI	Measure fair value at reclassification date and recognize any difference in OCI
FVOCI	Amortized Cost	Cumulative gain or loss previously recognized in OCI is removed from equity and applied against the fair value of the financial asset at the reclassification date
FVPL	FVOCI	Asset continues to be measured at fair value but subsequent gains and losses are recognized in OCI rather than profit and loss
FVOCI	FVPL	Asset continues to be recognized at fair value and the cumulative gain or loss previously recognized in other comprehensive income is reclassified from equity to profit and loss

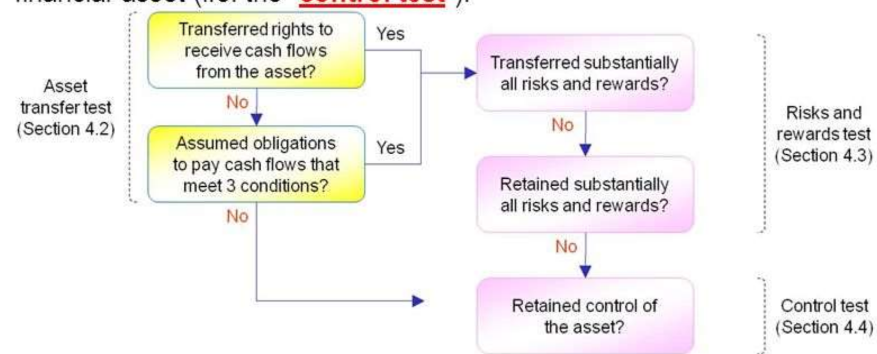
Derecognition of Financial Assets & Liabilities

Derecognition



4. Derecognition of a Financial Asset

- If an entity concludes that it neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset,
  - it will be required to determine whether it has retained control of the financial asset (i.e. the "**control test**").



On derecognition, the difference between the carrying amount of the asset or liability and the amount received or paid for it should be recognized in the profit or loss for the period.

Impairment of Financial assets – the Lender

Impairment is when a Financial Asset cannot be recovered or will likely not be recovered. Based on prudence grounds and just like other assets, IFRS 9 requires that an entity provides for impairment losses or recognizes impairment losses on financial assets. For example, for loans and trade receivables, IFRS 9 suggests a criteria for computing expected credit losses (ECL).

The impairment requirements under IFRS 9 are applied to:

1.Financial assets measured at amortized cost (incl. trade receivables)

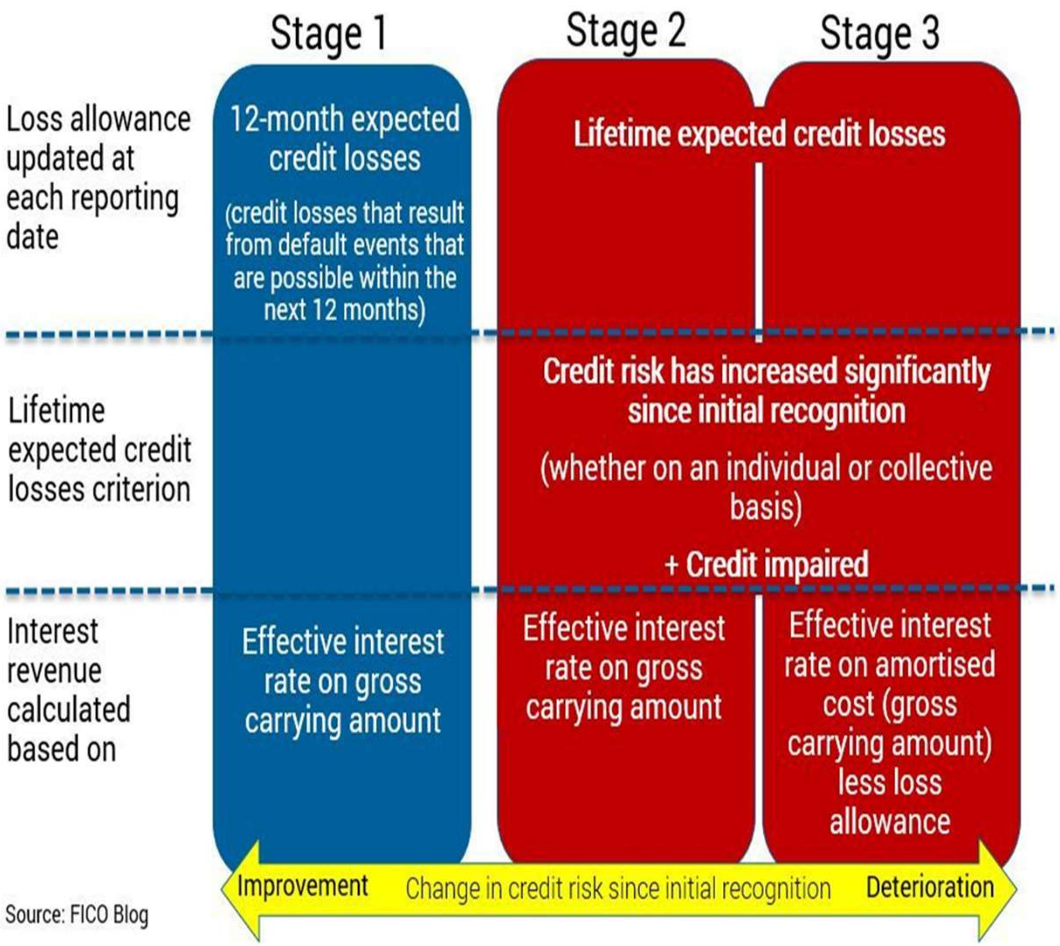
2.Financial assets measured at fair value through OCI

3.Loan commitments and financial guarantees contracts where losses are currently accounted for under IAS 37 Provisions, Contingent Liabilities and Contingent Assets

4. Lease receivables.

Impairment of Financial assets – the Lender

<u>1. The general model for measuring a loss allowance (Expected Credit Loss)</u>:
This model recognizes loss allowance depending on the stage in which the financial asset is. There are 3 stages:
Stage 1 – **Performing assets (Low credit risk)**: Loss allowance is recognized in the amount of 12-month expected credit loss;
Stage 2 – **Financial assets with significantly increased credit risk**: Loss allowance is recognized in the amount of lifetime expected credit loss, and
Stage 3 – **Credit-impaired financial assets**: Loss allowance is recognized in the amount of lifetime expected credit loss and interest revenue is recognized based on amortized cost.



Impairment of Financial assets – the Lender

Stage 1	Stage 2	Stage 3
Deterioration of credit quality since initial recognition		
12-month ECLs = $5,000 ($50,000 × 10%) which are the ECLs that result from default events on a financial instrument that are possible within the next 12 months. **2018 interest revenue** = $30,000 (3% × $1,000,000) which is based on the effective interest rate applied to the gross carrying amount (which is the amortized cost before adjusting for any loss allowance).	**Lifetime ECLs** = $50,000 ($100,000 × 50%) which are the ECLs that result from all possible default events over the expected life of the instrument. The change in the cumulative impairment allowance is recognized in profit or loss as $45,000. **2019 interest revenue** = $30,000 (3% × $1,000,000) which is based on the effective interest rate applied to the gross carrying amount (which is the amortized cost before adjusting for any loss allowance).	**Lifetime ECLs** = $230,000 ($1,030,000 - $800,000) The change in the cumulative impairment allowance of $180,000 is recognized in profit or loss. **2020 interest revenue** = $30 (3% × $1,000,000) interest revenue in 2020. **2021 interest revenue** = $24,000 (3% × $800,000) which is based on the effective interest rate applied to the amortized cost (gross carrying amount minus loss allowance) of the instrument from the date it became credit-impaired.

** Only an increase in credit risk vs. credit-impaired because there is no conclusive evidence at that time that Entity B will not pay (i.e., although late on interest payments during the year, there are no outstanding amounts at the reporting date).*

Impairment of Financial assets – the Lender (Example)

Example of Probability of Default Approach *(Adapted from IFRS 9.IE49-IE50 Example 8: Scenario 1)*

Mortgage Investment Company Y (MICY) provided a 10-year residential mortgage for $2,000,000.

At initial recognition of the mortgage, MICY determines the following on the basis of the most relevant and supportable information available:

- A 12-month probability of default (PD) of 0.75% when considering historical results and current expectations of similar financial instruments, the borrower's financial condition and economic forecasts for the next 12 months.
- It has been determined that the changes in the 12-month PD reasonably approximate the lifetime PD when assessing if there has been significant increase in credit risk.
- The Loan Given Default (LGD) is 25% - i.e., the estimated loss amount of the gross carrying amount of the loan if it were to default.

Assessment: There has been no change in the 12-month PD nor a significant increase in credit risk since initial recognition. Therefore, the mortgage falls in Stage 1. MICY calculates the 12-month ECL allowance as $3,750 ($2,000,000 x 0.75% PD x 25% LGD).

Impairment of Financial assets – the Lender

2. Simplified Approach

A Ltd. has reasonably supportable information that indicates that economic conditions will deteriorate over the next year. Therefore, the historical loss rates were adjusted to reflect this forward-looking information. To determine the ECLs for the other receivables, A Ltd. uses a provision matrix. As previously discussed, the provision matrix uses historically observed default rates over the expected life of the trade receivables, adjusted for current conditions and forward-looking estimates. At every reporting date, A Ltd. reviews and adjusts its historically observed default rates based on current conditions and changes in the future forecasts.

Therefore, based on the historical loss rate adjusted for forward-looking information, the total provision for ECLs under IFRS 9 would be as follows:

Aging	Trade Receivables Balance ($)	Historical Loss Rates Adjusted for Current Conditions and Forward-Looking Information (%)	Provision for ECLs ($ × %)
Not past due	$748,400	0.50%	$3,742
1-30 days	104,600	0.80	837
31-90 days	55,200	5.60	3,091
91-180 days	26,400	8.90	2,350
181-365 days	15,000	20.30	3,045
365+ days	10,000	63.90	6,390
Debtor Z	40,400	100.00	40,400
Total	**$1,000,000**	**n/a**	**$59,855**

The calculations assume that the ECLs represented by the historical loss rates adjusted for forward-looking information has a 100% probability of occurring. Hence, there is an implied probability of 0% that no loss will occur. In addition, the receivables are short-term and hence no discounting of the impairment allowance is necessary.

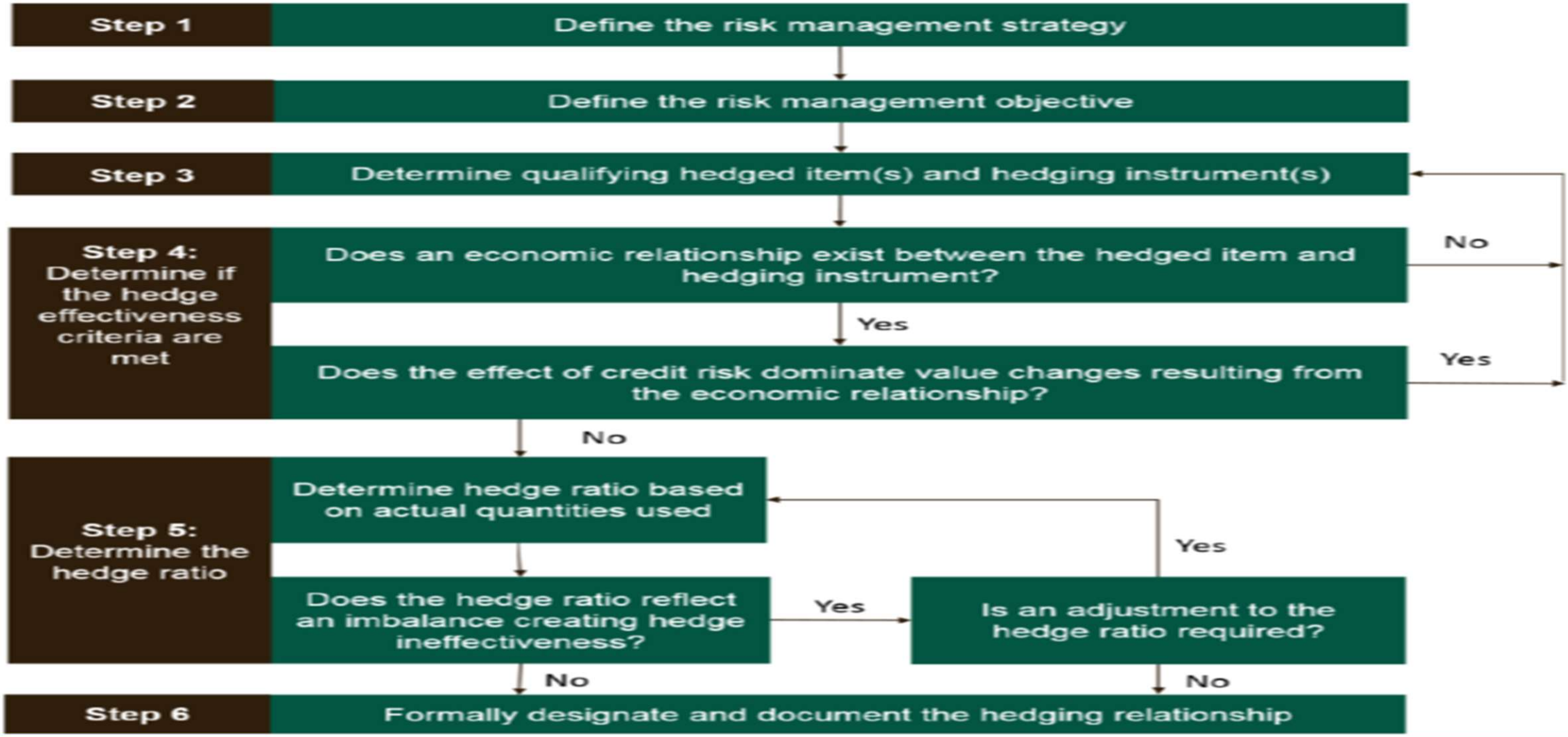
Hedging by the Lender and the Borrower

Hedge accounting	is a method of managing risk by designating one or more hedging instruments so that their change in fair value is offset, in whole or in part, by the change in fair value or cash flows of a hedged item.
Hedged item	A hedged item is an asset or liability that exposes the entity to risks of changes in fair value or future cash flows (and is designated as being hedged). There are 3 types of hedged item: ▪ A recognised asset or liability ▪ An unrecognised firm commitment – a binding agreement for the exchange of a specified quantity of resources at a specified price ona specified future date ▪ A highly probable forecast transaction – an uncommitted but anticipated future transaction.
Hedging instrument	A hedging instrument is a designated derivative, or a non-derivativefinancial asset or financial liability, whose fair value or cash flows are expected to offset changes in fair value or future cash flows of the hedgeditem.

Hedging by the Lender and Borrower

Classification of hedging relationships	'**Fair value hedge:** a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment that is attributable to a particular risk and could affect profit or loss (or other comprehensive income for equity investments measured at fair value through other comprehensive income). **Cash flow hedge:** a hedge of the exposure to variability in cash flows thatis attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and that could affect profit or loss'
Conditions	Under IFRS 9, hedge accounting rules can only be applied if the hedging relationship meets the following criteria: ▪ The hedging relationship consists only of eligible hedging instruments and hedged items. ▪ At the inception of the hedge there must be formal documentation identifying the hedged item and the hedging instrument. ▪ The hedging relationship meets all effectiveness requirements

Hedging by the Lender and Borrower – Qualifying Criteria



Hedging by the Lender and Borrower

Fair Value Hedge

At the reporting date:

- The hedging instrument will be remeasured to fair value.
- The carrying amount of the hedged item will be adjusted for the change in fair value since the inception of the hedge.

The gain (or loss) on the hedging instrument and the loss (or gain) on the hedged item willbe recorded:

- in profit or loss in most cases, but
- in other comprehensive income if the hedged item is an investment in equity that is measured at fair value through other comprehensive income.

Hedging by the Lender and Borrower

Cash Flow Hedge	
Main treatment	For cash flow hedges, the hedging instrument will be remeasured to fair value at the reporting date. The gain or loss is recognized in other comprehensive income. However, if the gain or loss on the hedging instrument since the inception ofthe hedge is greater than the loss or gain on the hedged item then the excess gain or loss on the instrument must be recognized in profit or loss.
Eventually resulting in financial item	If the hedged item eventually results in the recognition of a financial asset or a financial liability, the gains or losses that were recognized in equity shall be reclassified to profit or loss as a reclassification adjustment in the same period during which the hedged forecast cash flows affect profit or loss (e.g. in the period when the hedged forecast sale occurs).
Eventually resulting in non-financial item	If the hedged item eventually results in the recognition of a non-financial asset or liability, the gain or loss held in equity must be adjusted against thecarrying amount of the non-financial asset/liability. This is not a reclassification adjustment and therefore it does not affect other comprehensive income.

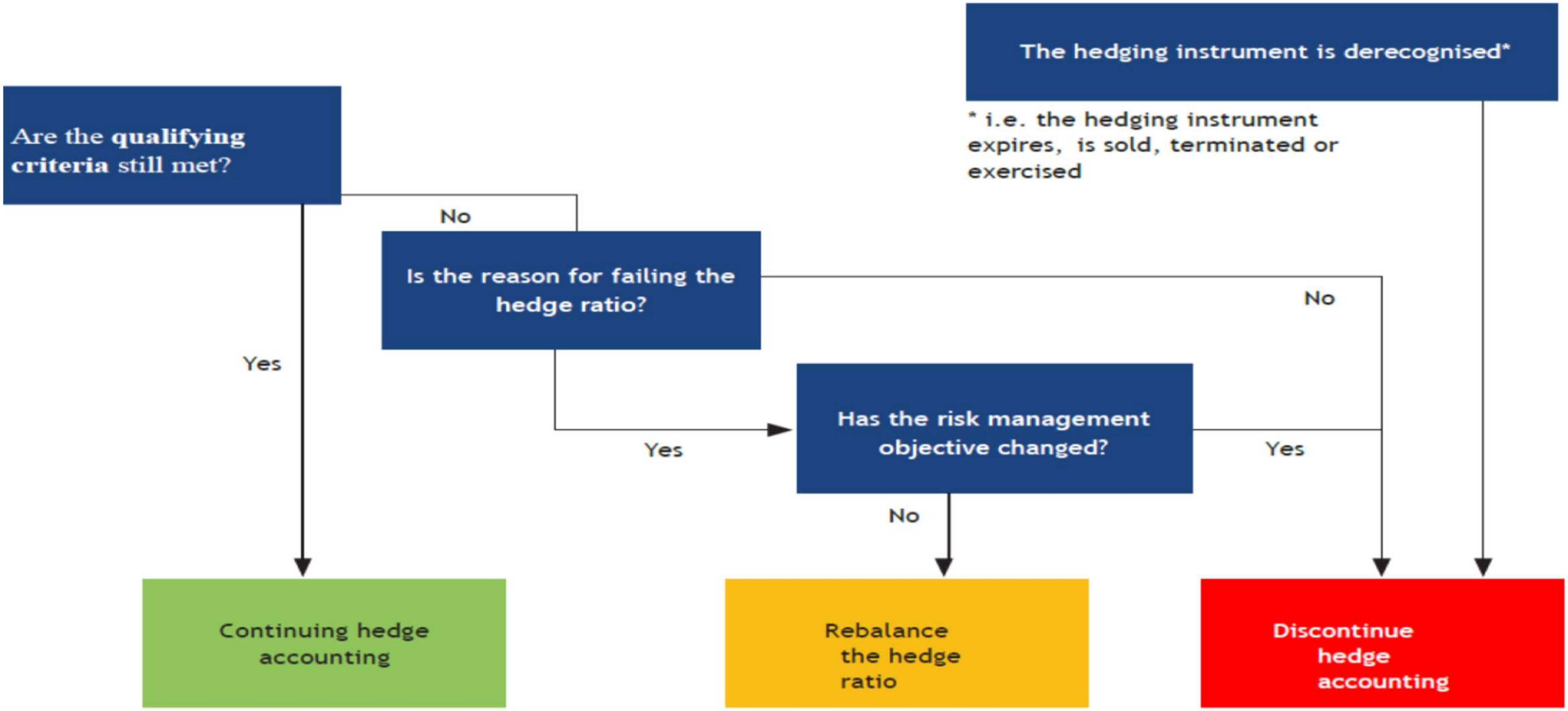
Hedging by the Lender and Borrower

Rebalancing and Discontinuation of Hedging

If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, an entity is required to adjust the hedge ratio of the hedging relationship (i.e. rebalances the hedge) so that it meets the qualifying criteria again.

An entity discontinues hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after any rebalancing). This includes instances when the hedging instrument expires or is sold, terminated or exercised. Discontinuing hedge accounting can either affect a hedging relationship in its entirety or only a part of it (in which case hedge accounting continues for the remainder of the hedging relationship). Unlike under IAS 39, hedge accounting may not be voluntarily discontinued if the criteria for discontinuation are not met.

Hedging by the Lender and Borrower



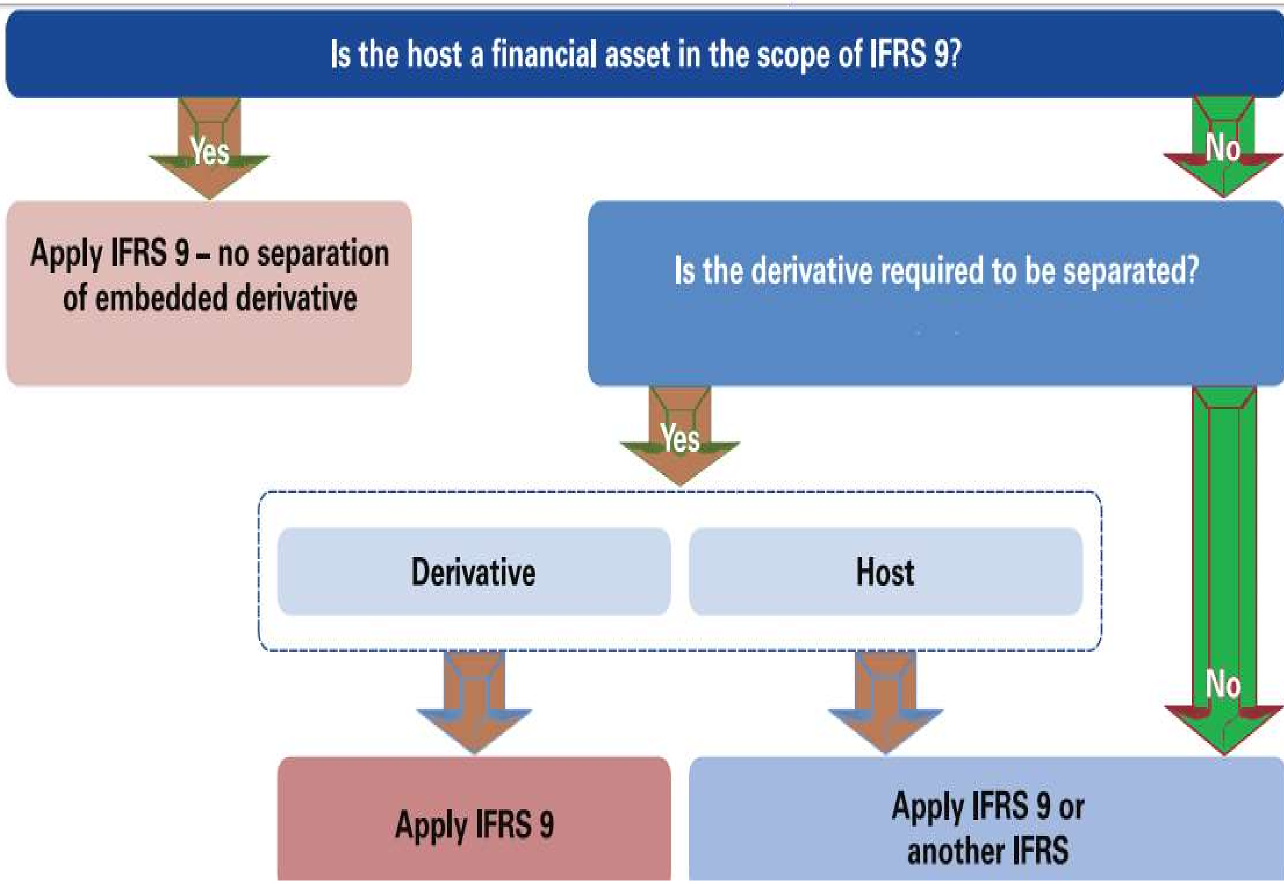
Embedded Derivatives – The Lender and the Borrower

Definition : Embedded Derivatives

- A component of a hybrid instrument that combines the derivative and a host contract
- Example : Convertible bond
  - host contract = the bond
  - embedded derivative = call option on share

Should you separate out the embedded and account for the two elements separately?

Embedded Derivatives – The Lender and the Borrower



Criteria to separate the host contract

1) Economic characteristics of the embedded derivative and host are not closely related
2) An identical instrument (with the same terms) would meet the definition of a derivative, and
3) The entire (hybrid) contract is not measured at fair value through profit or loss.