

IFRS 9 Financial Instruments

▪ Financial Instruments Standards

- IAS 32 Financial Instruments: Presentation
- IFRS 7 Financial Instruments: Disclosure
- IFRS 9 Financial Instruments:
 - ❖ Classification and measurement of financial assets and liabilities
 - ❖ Impairment – “incurred loss vs expected loss”
 - ❖ Hedge Accounting- F.V hedge, C.F hedge and Net Investment

▪ Background

- IFRS 9 Financial Instruments effective date is 1 January 2018, replaced IAS 39 Financial Instruments: recognition and measurement
- IAS 39 contained many different classification categories and associated impairment models. Many of the application issues that arose with IAS 39 were related to the classification and measurement of financial assets.

▪ Classification and measurement

- classification determines how financial assets are accounted for in financial statements and, in particular, how they are measured on an ongoing basis.
- requirements for classification and measurement are the foundation of the accounting for financial instruments.
- the requirements for impairment and hedge accounting are based on that classification.

▪ The classification and measurement approach

- IFRS 9 applies one classification approach for all types of financial assets, including those that contain embedded derivative features.
- two criteria are used to determine how financial assets should be classified and measured:
 - ❖ the entity’s business model for managing the financial assets; and
 - ❖ the contractual cash flow characteristics of the financial asset.

▪ What is a business model?

- refers to how an entity manages its financial assets in order to generate cash flows
 - ❖ by collecting contractual cash flows,
 - ❖ selling financial assets
 - ❖ or both.

▪ **What business model qualifies for amortised cost?**

- financial assets at amortised cost are held in a business model whose objective is to hold assets in order to collect contractual cashflows

▪ **What business model qualifies for fair value through other comprehensive income (FVOCI)?**

- financial assets classified and measured at fair value through other comprehensive income are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

▪ **Other business models**

- any financial assets that are not held in one of the two business models mentioned above are measured at fair value through profit or loss.
- fair value through profit or loss represents a ‘residual’ category. Financial assets that are held for trading and those managed on a fair value basis are also included in this category.

▪ **Contractual cash flow characteristics**

- One of the criteria for determining the classification of a financial asset is whether the contractual cash flows are solely payments of principal and interest (SPPI).
- Only financial assets with such cash flows are eligible for amortised cost or fair value through other comprehensive income measurement dependent on the business model in which the asset is held.
- Often it will be readily apparent whether contractual cash flows meet the SPPI criteria but sometimes closer analysis is required. IFRS 9 now provides more extensive guidance on SPPI. Importantly, it has been clarified that interest can comprise a return not only for the

time value of money and credit risk but also for other components such as a return for liquidity risk, amounts to cover expenses and a profit margin.

- For contractual cash flows to be SPPI they must include returns consistent with a basic lending arrangement, so for example, if the contractual cash flows include a return for equity price risk then that would not be consistent with SPPI.

▪ **Financial liabilities and own credit**

• **Financial liabilities in IFRS 9**

- ❖ IAS 39's treatment of financial liabilities has been carried forward to IFRS 9 essentially unchanged.
- ❖ This means that most financial liabilities continue to be measured at amortised cost.
- ❖ IFRS 9 includes the same option as IAS 39 that permits entities to elect to measure financial liabilities at fair value through profit or loss if particular criteria are met. For example, an entity can choose to measure a structured financial liability at fair value in its entirety rather than being required to account for its component parts. This is referred to as the fair value option (FVO).

• **Own credit**

- ❖ Under IAS39 there was a problem was the volatility in profit or loss caused by changes in the credit risk of financial liabilities that an entity has elected to measure at fair value.
- ❖ The fair value of an entity's own debt is affected by changes in the entity's own credit risk (own credit).
- ❖ This means, somewhat counterintuitively, that when an entity's credit quality declines the value of its liabilities fall, and if those liabilities are measured at fair value a gain is recognised in profit or loss (and vice versa).
- ❖ IFRS 9 requires changes in the fair value of an entity's own credit risk to be recognised in other comprehensive income rather than in profit or loss.
- ❖ Such liabilities would continue to be measured in the balance sheet at fair value, which provides information that was confirmed to be useful by users of financial statements.

▪ **Impairment [A forward-looking impairment model]**

• **Why did the IASB address impairment?**

- ❖ During the financial crisis, the delayed recognition of credit losses on loans (and other financial instruments) was identified as a weakness in existing accounting standards.
- ❖ Specifically, the model in IAS 39 (an ‘incurred loss’ model) delayed the recognition of credit losses until there is evidence of a trigger event. This was designed to limit an entity’s ability to create hidden reserves that can be used to flatter earnings during bad times.
- ❖ As the financial crisis unfolded, it became clear that the incurred loss model gave room to a different kind of earnings management, namely to postpone losses. Even though IAS 39 did not require waiting for actual default before impairment is recognised, in practice this was often the case.

• **Overview of the impairment requirements**

❖ **Stage 1**

As soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognised in profit or loss and a loss allowance is established. This serves as a proxy for the initial expectations of credit losses. For financial assets, interest revenue is calculated on the gross carrying amount (i.e without adjustment for expected credit losses)

❖ **Stage 2**

If the credit risk increases significantly and the resulting credit quality is not considered to be low credit risk, full lifetime expected credit losses are recognised. Lifetime expected credit losses are only recognised if the credit risk increases significantly from when the entity originates or purchases the financial instrument. The calculation of interest revenue on financial assets remains the same as for stage 1.

❖ **Stage 3**

If the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the amortised cost (i.e the gross carrying amount adjusted for the loss allowance). Financial assets in this

stage will generally be individually assessed. Lifetime expected credit losses are still recognised on these financial assets.

- **What are 12-month expected credit losses?**

- ❖ 12-month expected credit losses are the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date. It is not the expected cash shortfalls over the next twelve months—instead, it is the effect of the entire credit loss on an asset weighted by the probability that this loss will occur in the next 12 months. It is also not the credit losses on assets that are forecast to actually default in the next 12 months. If an entity can identify such assets or a portfolio of such assets that are expected to have increased significantly in credit risk, lifetime expected credit losses are recognized

- **What are lifetime expected credit losses?**

- ❖ are an expected present value measure of losses that arise if a borrower defaults on their obligation throughout the life of the financial instrument. They are the weighted average credit losses with the probability of default as the weight.

Disclosure

In addition to improving the accounting for impairment, the new model is accompanied by improved disclosure about expected credit losses and credit risk. Entities are required to provide information that explains the basis for their expected credit loss calculations and how they measure expected credit losses and assess changes in credit risk. In addition, entities are required to provide a reconciliation from the opening to the closing allowance balances for 12-month loss allowances separately from lifetime loss allowance balances. This is provided along with a reconciliation from the opening to the closing balances of the related carrying amounts of financial instruments subject to impairment.