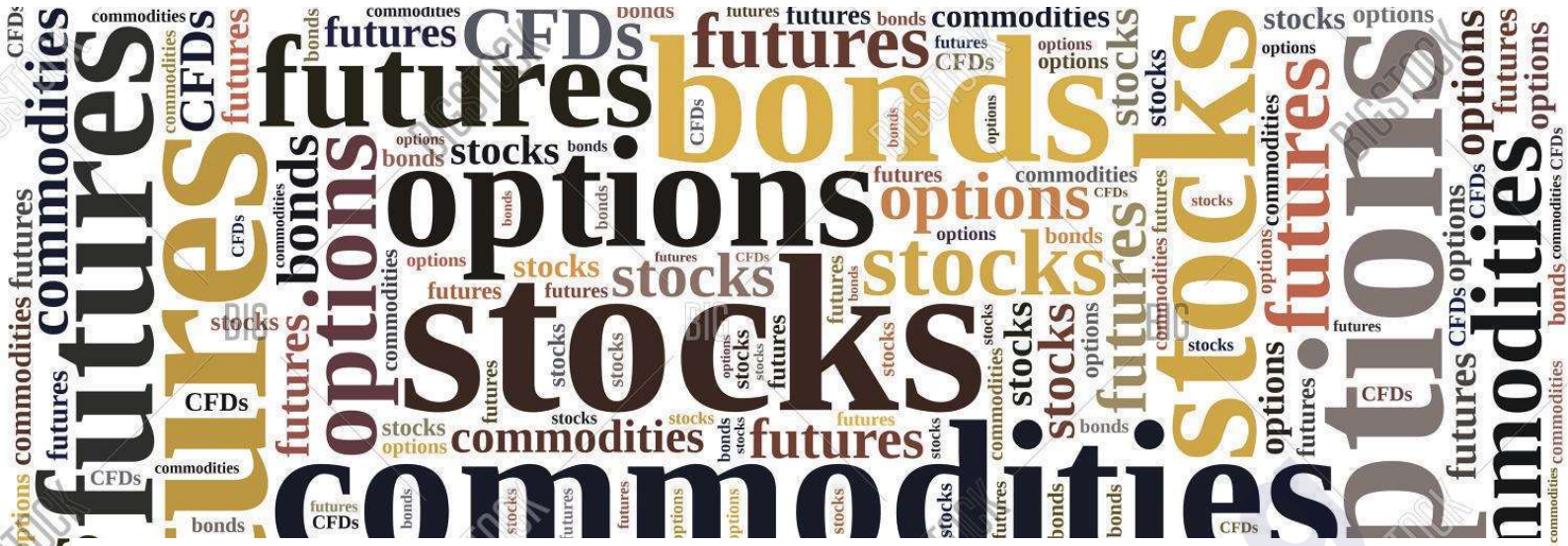


IFRS 09(SLFRS 09)

FINANCIAL INSTRUMENTS

Source :

BDO - IFRS IN PRACTICE 2016 / CASL - SLFRS 09

Statement of Financial Position

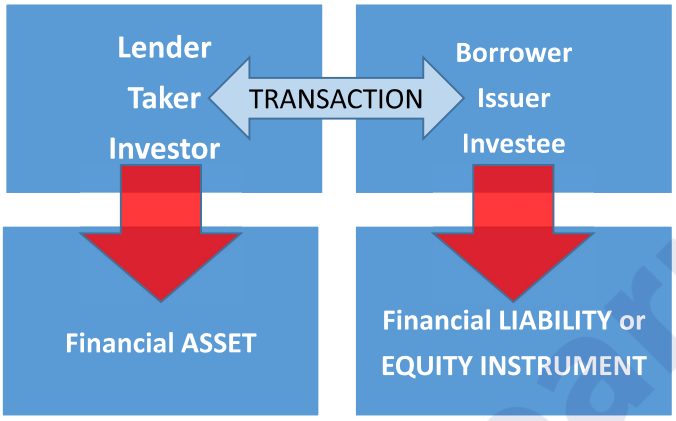
Equity & Liabilities		Assets	
Stated Ordinary Share Capital		PPE	(LKAS 16)
Retained Earnings		Intangible Assets	(LKAS 38)
Preference Shares		Biological Assets	(LKAS 41)
Long Term loans		Investment Property	(LKAS 40)
Debentures			
Finance Lease Creditors	(LKAS 17)	Long Term Investments	
Deferred Tax Liability	(LKAS 12)	Investment in Subsidiaries	(LKAS 27)
		Investment in Associates	(LKAS 28)
		Investment in Joint Ventures	(SLFRS 11)
		Other Investments	
Contingent Consideration	(SLFRS 03)	Inventories	(LKAS 02)
Trade Creditors & Payables		Trade & Other Receivables	
Income Tax Payable	(LKAS 12)	Pre – Paid Expenses	
Short Term Borrowings		Short Term Investments	
		Cash / Bank Balances	

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.***

This means that items that will be settled through the receipt or delivery of goods or services are not financial instruments, nor typically are tax assets and liabilities as these arise through legal rather than contractual requirements.



A financial asset is defined as any asset that is:

✓ Cash

✓ A contractual right

- To receive cash or another financial asset from another entity
- To exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity

✓ An equity instrument of another entity

✓ A contract that will or may be settled in the entity's own equity instruments and is:

- A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
- A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include puttable equity instruments or instruments that include a contractual obligation for the entity to deliver a pro rata share of its net assets only on liquidation, that do not meet the definition of equity but are classified as such under IAS 32 *Financial Instruments: Presentation*, nor do they include instruments that are contracts for the future receipt or delivery of an entity's own equity instruments.

A financial liability is defined as any liability that is:

A contractual obligation

- To deliver cash or another financial asset to another entity
- To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity

A contract that will or may be settled in the entity's own equity instruments and is:

- A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
- A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include certain instruments as set out above in the equivalent part of the definition of financial assets.

An equity instrument is defined as:

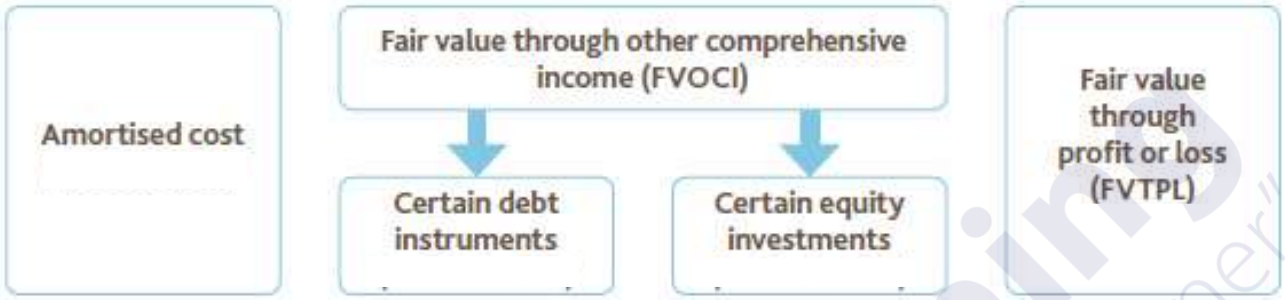
Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

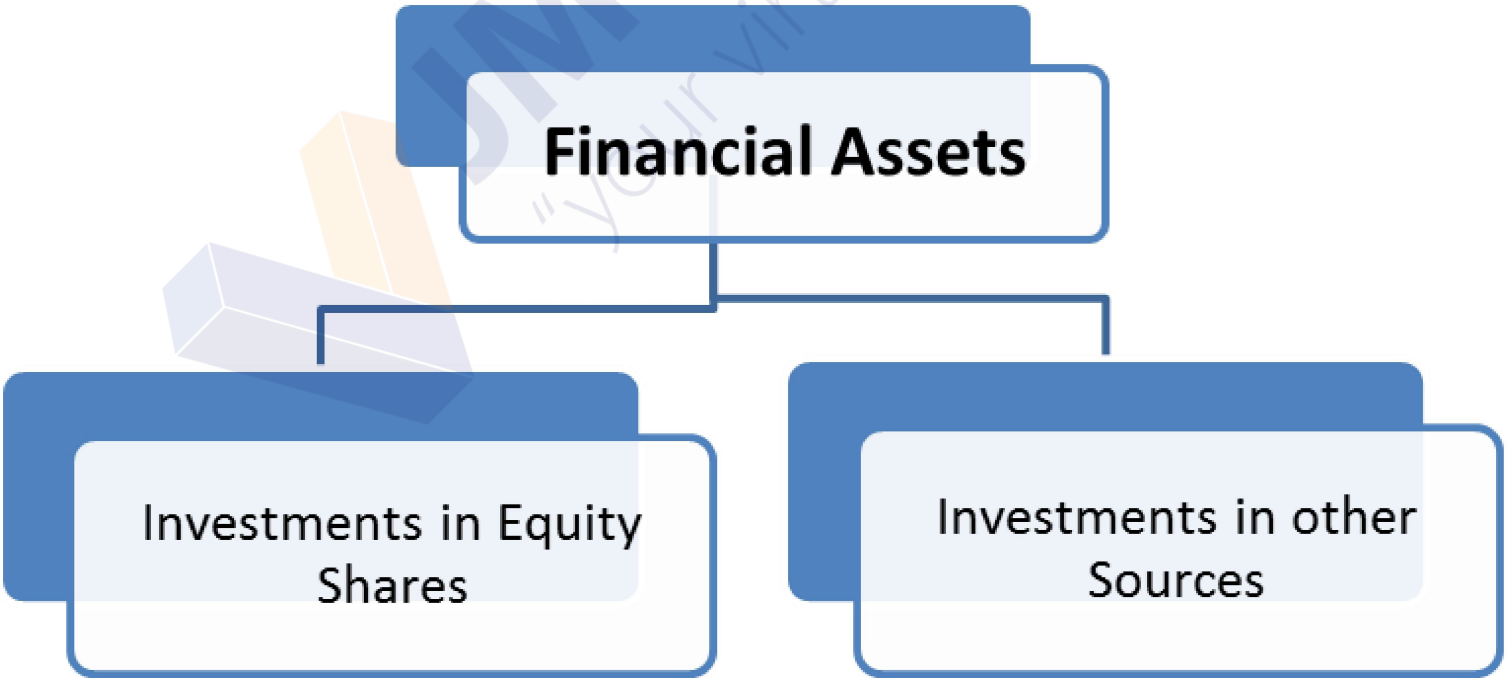
Certain financial instruments that meet the definition of a financial liability are classified as equity instruments. These are:

- Puttable financial instruments that meet certain specified conditions
- Financial instruments which contain a contractual obligation for the issuing entity to deliver to the holder a pro rata share of its net assets only on liquidation, but liquidation is either certain to occur and outside the control of the entity (eg for a limited life entity) or is uncertain to occur but can be triggered at the option of the instrument holder.

FINANCIAL ASSETS
SLFRS 9 *Financial* Assets (Classification)

IFRS 9 *Financial Instruments* has introduced a number of new measurement categories, whilst eliminating some of the previous categories under IAS 39 *Financial Instruments: Recognition and Measurement*. Under IFRS 9, financial assets are classified into one of the four categories:

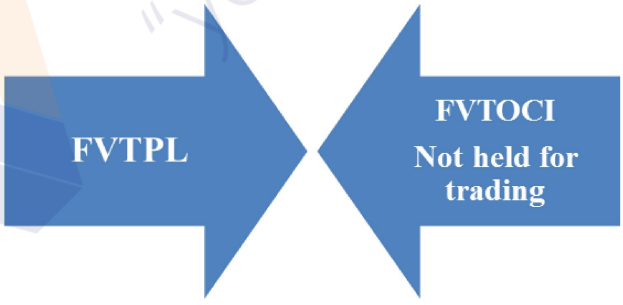




- **Investments in other Sources**

		Business Models		
		Hold to Collect	*Hold collect and Sell*	*other*
Cash Flow Type	*Solely Payments of Principle and Interest (SPPI test)*	Amortized Cost	FVTOCI	FVTPL
	other	FVTPL	FVTPL	FVTPL

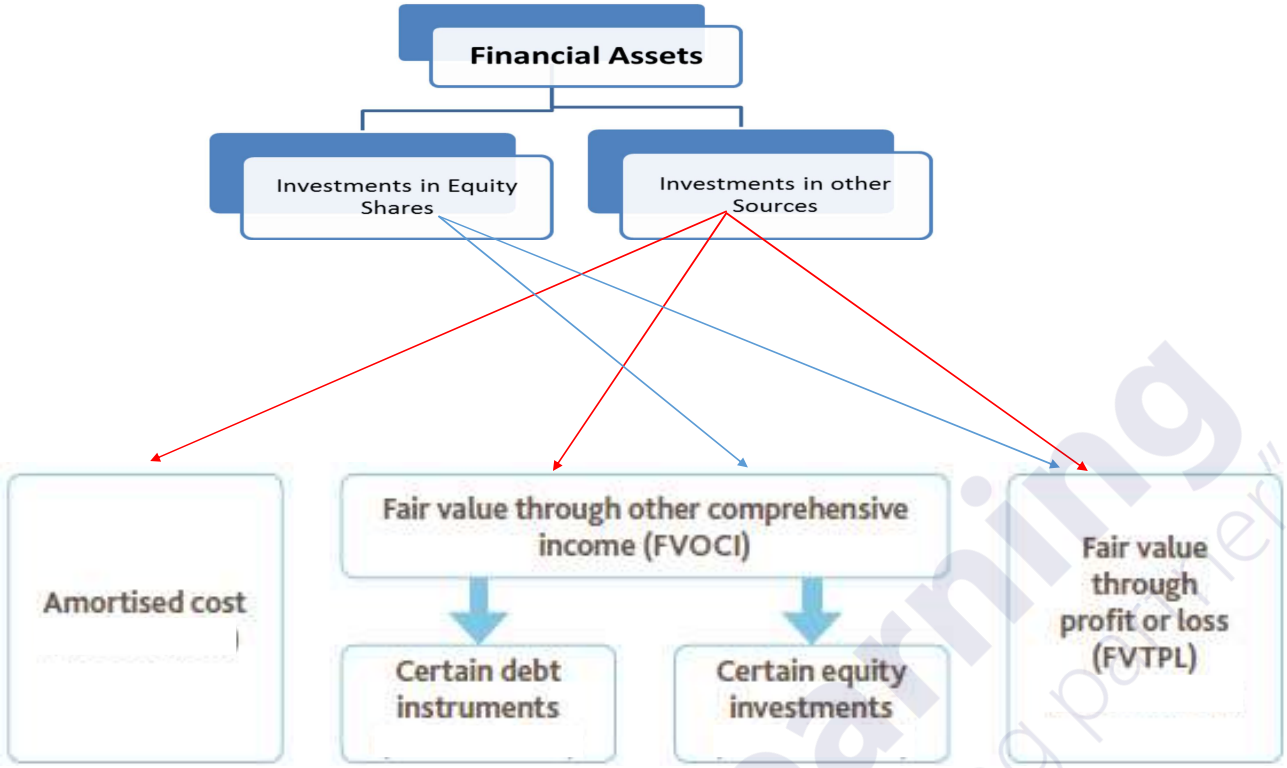
- **Investments in Equity Shares (@ FV only)**



Notice:

The exception to measure investments in unquoted equity instruments at cost has been eliminated

Classification summery – Financial Assets



Amortized cost

A financial asset is classified as subsequently measured at amortized cost under IFRS 9 if it meets both of the following criteria:

- ***'Hold-to-collect' business model test*** – The asset is held within a business model whose objective is to hold the financial asset in order to collect contractual cash flows; and
- ***'SPPI' contractual cash flow characteristics test*** – The contractual terms of the financial asset give rise to cash flows that are ***solely payments of principal and interest (SPPI)*** on the principal amount outstanding on a specified date.

Examples of financial instruments that are likely to be classified and accounted for at amortized cost under IFRS 9 include:

- Trade receivables
- Loan receivables with 'basic' features
- Investments in government bonds that are not held for trading
- Investments in term deposits at standard interest rates.

'Hold-to-collect' business model

To qualify for amortized cost classification, the financial asset must be in a 'hold-to-collect' business model.

That is, it must be in a business model in which the entity's objective is to hold the financial asset to collect the contractual cash flows from the financial asset rather than with a view to selling the asset to realize a profit or loss.

For example, trade receivables held by a manufacturing entity are likely to fall within the 'hold-to-collect' business model, as the manufacturing entity is likely to have the intention to collect the cash flows from those trade receivables.

The 'hold-to-collect' business model does not require that financial assets are always held until their maturity. An entity's business model can still be to hold financial assets to collect contractual cash flows, even when sales of financial assets occur. However, if more than an ***infrequent number of sales are made out of a portfolio,*** the entity should assess whether and how the sales are consistent with the 'hold-to-collect' objective. This assessment should include the reason(s) for the sales, the expected frequency of sales, and whether the assets that are sold are held for an extended period of time relative to their contractual maturities.

Example 1 – 'Hold-to collect' business model

Entity A sold one of its diverse business operations and currently has CU10 million of cash. It has not yet found another suitable investment opportunity in which to invest those funds so it buys short dated (6 month maturity) high quality government bonds in order to generate interest income. It is not considered likely but, if a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. Otherwise it will hold the bonds to their maturity date.

Question: Is the 'hold-to-collect' business model test met?

Answer:

Consideration of the facts and circumstances are required. It is likely that the government bonds would meet the 'hold-to-collect' business model test, as the entity's objective appears to be holding the government bonds and collecting the contractual cash flows which consist of the contractual interest payments and, on maturity, the principal amount. If the bond were to be sold prior to its maturity date, the fair value of the cash flows arising would be similar to those which would be collected by continuing to hold the bonds.

Note:- For more Examples on ***Hold – to – Collect*** model:
SLFRS 09
Paragraph B4.1.4

The 'SPPI' contractual cash flow characteristics test

The second condition for a financial asset to qualify for amortized cost classification is that the financial asset must meet the 'SPPI' contractual cash flow characteristics test.

Contractual cash flows are considered to be SPPI if the contractual terms of the financial asset only give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding on specified dates i.e. the contractual cash flows are consistent with a basic lending arrangement.

Note:- For more Examples on ***SPPI*** model:
SLFRS 09
Paragraph B4.1.13

For more Examples on **not for *SPPI*** model:
SLFRS 09
Paragraph B4.1.14

Example 2 – SPPI test for loan with zero interest and no fixed repayment terms

Parent A provides a loan to Subsidiary B. The loan is classified as a current liability in Subsidiary B's financial statements and has the following terms: —No interest —No fixed repayment terms —Repayable on demand of Parent A.

Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Answer: **Yes**. The terms provide for the repayment of the principal amount of the loan on demand.

Example 3 – SPPI test for loan with zero interest repayable in five years

Parent A provides a loan of CU10 million to Subsidiary B. The loan has the following terms: —No interest —Repayable in five years.

Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Answer: **Yes**. The principal (fair value) is CU10 million discounted to its present value using the market interest rate at initial recognition. The final repayment of CU10 million represents a payment of principal and accrued interest.

Example 4 – SPPI test for a loan with interest rate cap

Entity B lends Entity C CU5 million for five years, subject to the following terms: —Interest is based on the prevailing variable market interest rate —Variable interest rate is capped at 8% —Repayable in five years. **Question: Does the loan meet the SPPI contractual cash flows characteristic test?**

Answer: **Yes**. Contractual cash flows of both a fixed rate instrument and a floating rate instrument are payments of principal and interest as long as the interest reflects consideration for the time value of money and credit risk. Therefore, a loan that contains a combination of a fixed and variable interest rate meets the contractual cash flow characteristics test.

Example 5 – SPPI test for loan with profit linked element

Entity D lends Entity E CU500 million for five years at an interest rates of 5%. Entity E is a property developer that will use the funds to buy a piece of land and construct residential apartments for sale. In addition to the 5% interest, Entity D will be entitled to an additional 10% of the final net profits from the project.

Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Answer: **No**. The profit linked element means that the contractual cash flows do not reflect only payments of principal and interest that consist of only the time value of money and credit risk. Therefore, the loan will fail the requirements for amortised cost classification. Entity D will account for the loan at fair value through profit or loss.

Example 6 – SPPI test: Modified time value of money

Entity B invests in a variable interest rate bond that matures in five years. The variable interest is reset every six months to a 5 year rate. At the time of initial investment, the 6 month interest rate is not significantly different to the 5 year rate.

Question: Can Entity B conclude that the modification is not significant without any additional analysis?

Answer: **No**. Entity B cannot simply conclude based on the relationship between the 5 year rate and the 6 month rate at the date of initial investment. Rather Entity B must also consider whether the relationship between the 5 year interest rate and the 6 month interest rate could change over the life of the bond such that the contractual (undiscounted) cash flows over the life of the bond could be significantly different from the (undiscounted) benchmark cash flows. Entity B is only required to consider reasonably possible scenarios rather than every possible scenario. If Entity B is unable to conclude that the contractual (undiscounted) cash flows could not be significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the SPPI criteria and therefore must be measured at fair value through profit or loss.

Example 7 – SPPI test for loan with prepayment option

Entity D lends Entity E CU5 million at a fixed interest rate. The loan is repayable in 5 years. Entity E has the option to repay the loan at any time at CU5 million plus any accrued interest plus a prepayment penalty fee of 2.5% which reduces by 0.5% for each complete period of one year during which the loan has been outstanding.

Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Answer: **Yes**. The prepayment option is not contingent on any future event. The prepayment penalty is considered to be reasonable additional compensation for early contract termination.

Example 8 – SPPI test for loan with extension option (with rate reset)

Company K lends Company L CU10 million at a fixed market interest rate. The loan is repayable in 5 years. Company L has the right to extend the term for another 3 years. If Company L decides to extend the loan, a variable market interest rate will be charged from year 6 to 8.

Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Answer: **Yes**. Extension options meet the SPPI test if the terms result in contractual cash flows during the extension period that are SPPI on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract (IFRS 9.B.4.1.11(c)).

Example 9 – SPPI test for loan with extension option (with no rate reset)

Company M lends Company N CU10 million at a fixed market interest rate of 5%. The loan is repayable in 5 years. Company N has the right to extend the term for another 3 years at the original fixed interest rate of 5%.

Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test during the extension period?

Answer: **Yes**. This is because the coupon rate is fixed at inception of the loan, and the rate is not leveraged. The contractual terms of the loan require the principal amount to be advanced at inception and repaid on maturity. There are no other cash flow or contingent features. Note this is different to the accounting requirement under IAS 39 where the extension option is considered to be an embedded derivative that is not closely related under the guidance in paragraph IAS 39.AG30(c) and therefore needs to be separately accounted for at fair value through profit or loss (unless the entity elects to measure the entire loan at fair value through profit or loss).

Example 10 – SPPI test for loan with interest rate reset

Company I lends Company J CU5 million at a fixed interest rate of 8%. The loan is repayable in five years. If Company J misses two interest payments, the interest rate is reset to 15%.

Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Answer: **Yes**, because there is a relation between the missed payment and an increase in credit risk (IFRS 9.B4.1.10).

Example 11 – SPPI test for convertible note

Question:

Does an investment in a convertible note that converts into equity instruments of the issuer meet the 'SPPI' contractual cash flows characteristic test?

Answer:

No. IFRS 9 requires analysis of the terms of the convertible bond in its entirety. The interest rate in a convertible note typically does not reflect the consideration for the time value of money and the credit risk. The interest rate is usually set lower than the market interest rate. The overall return is also linked to the value of the equity of the issuer such that the conversion feature would potentially enhance the overall return.

Example 12 – SPPI test for commodity linked note

Question: Does an investment in a bond with contractual interest payments linked to a commodity price (e.g. the price of gold, copper etc.) meet the 'SPPI' contractual cash flows characteristic test?

Answer:

No, because the interest rate reflects the changes in the specified commodity price and not compensation for the time value of money and credit risk.

Example 13 – SPPI test for deferred consideration receivable in a business combination

Company O sold one of its subsidiaries to Company P. The purchase consideration consists of a deferred payment of CU10 million payable in two years.

Question: Does the receivable meet the 'SPPI' contractual cash flows characteristic test?

Answer:

Yes, the initial principal (fair value) is CU10 million discounted at the market interest rate for two years. The payment of CU10 million represents principal and accrued interest.

Debt instruments at FVOCI

Note:- For more Examples on ***Hold – to – Collect and Sell*** model:
SLFRS 09
Paragraph B4.1.4C

A financial asset is measured at fair value through other comprehensive income (FVOCI) under IFRS 9 if it meets both of the following criteria:

- 'Hold-to-collect and sell' business model test: The asset is held within a business model whose objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset, and
- 'SPPI' contractual cash flow characteristics 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.

Examples of financial instruments that may be classified and accounted for at FVOCI under IFRS 9 include:

Investments in government bonds where the investment period is likely to be shorter than maturity
Investments in corporate bonds where the investment period is likely to be shorter than maturity.

It is unlikely that intercompany loans or trade receivables would be classified in the FVOCI category.

Example 14 – 'Hold-to collect' business model test for sale before maturity

Same facts as Example 1: Entity A sold one of its diverse business operations and currently has CU10 million of cash. It has not yet found another suitable investment opportunity in which to invest its funds so it buys medium dated (3 year maturity) high quality government bonds in order to generate interest income. It is considered likely that a suitable investment opportunity will be found before the maturity date, and in that case Entity A will sell the bonds and use the proceeds for the acquisition of a business operation. Otherwise Entity A plans to hold the bonds to their contractual maturity.

Question: Are the criteria for a 'hold-to-collect' or 'hold-to-collect and sell' business model met?

Answer:

It is likely that the government bonds would not meet the 'hold-to-collect' business model test because it is considered likely that the bonds will be sold well before their contractual maturity. However, it is likely that the investment would meet the 'hold-to-collect and sell' business model test.

The accounting requirements for debt instruments classified as FVOCI are:

- Interest income is recognized in profit or loss using the effective interest rate method that is applied to financial assets measured at amortized cost
- Credit impairment losses/reversals are recognized in profit or loss using the same credit impairment methodology as for financial assets measured at amortized cost (please refer to Chapter 4 of this publication for further details).
- Other changes in the carrying amount on re-measurement to fair value are recognized in OCI
- The cumulative fair value gain or loss recognized in OCI is recycled from OCI to profit or loss when the related financial asset is derecognized.

Example 15 – FVOCI for debt instruments

On 1.1.20X1 a financial asset is purchased at its face value of CU1,000. The contractual term is ten years with an annual coupon of 6%. Expected credit losses as determined under the impairment model are CU20. On 31.12.20X1 the fair value of the financial asset decreases to CU950. Expected losses increase by CU10 to CU30. A coupon payment is received. On 1.1.20X2 the financial asset is sold for CU950. EIR 10%

Question: What are the journal entries on initial recognition, 31.12.20X1 and 1.1.20X2 under the FVOCI category?

Equity investments at FVOCI

IFRS 9 requires all equity investments to be measured at fair value.
The default approach is for all changes in fair value to be recognized in profit or loss.

However, for equity investments that are not held for trading, entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI, with all subsequent changes in fair value being recognized in other comprehensive income (OCI). This election is available for each separate investment.

Under this new FVOCI category, fair value changes are recognized in OCI while dividends are recognized in profit or loss.

Although it might appear similar to the Available for Sale category in IAS 39, it is important to note that this is a new measurement category which is different.

In particular under the new category, on disposal of the investment the cumulative change in fair value is required to remain in OCI and is not recycled to profit or loss. However entities have the ability to transfer amounts between reserves within equity (i.e. between the FVOCI reserve and retained earnings).

Example 16 – Equity investments classified at FVOCI

Entity X has a 31 December financial year end and pays tax at a rate of 30%. It prepares financial statements on an annual basis (it does not prepare interim financial statements). On 1 January 20X3, Entity X acquires 100 shares of List Co for CU10,000.

The journal entry at 1 January 20X3 is as follows:

Financial instruments at FVTPL

Fair value through profit or loss (FVTPL) is the residual category in IFRS 9. A financial asset is classified and measured at FVTPL if the financial asset is:

A held-for-trading financial asset
A debt instrument that does not qualify to be measured at amortized cost or FVOCI
An equity investment which the entity has not elected to classify as at FVOCI
A financial asset where the entity has elected to measure the asset at FVTPL under the fair value option (FVO).

Examples of financial instruments that are likely to fall under the FVTPL category include:

Investments in shares of listed companies that the entity has not elected to account for as at FVOCI

Derivatives that have not been designated in a hedging relationship,
e.g.: Interest rate swaps
Commodity futures/option contracts
Foreign exchange futures/option contracts

Investments in convertible notes, commodity linked bonds

Contingent consideration receivable from the sale of a business.

Example 17 – Contingent consideration receivable

Entity B owns five retail chains. It sold one of its retail chains to Entity C. As part of the purchase consideration, Entity B is entitled to additional consideration of CU3 million if the retail chain meets certain profit targets over the next 3 years.

Question: How should Entity B classify the contingent consideration receivable?

Answer:

The terms of the contingent consideration receivable fail the SPPI cash flow characteristics test because the payment is linked to the future profitability of the retail chain which has been sold. The contingent consideration receivable is measured at fair value through profit or loss.

Hybrid contracts containing embedded derivatives

A hybrid contract is a financial instrument that contains both a non-derivative host contract and an embedded derivative. Under IAS 39, the derivative embedded within a hybrid contract is bifurcated from the host contract and accounted for separately if:

- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative
- The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract, and
- The hybrid (combined) instrument is not measured at FVTPL.

In order to simplify the accounting, IFRS 9 has eliminated the requirement to separately account for embedded derivatives for financial assets. Instead,

IFRS 9 requires entities to assess the hybrid contract as a whole for classification. If the terms of the hybrid contract still meet the criteria for subsequent measurement at amortized cost or FVOCI for debt instruments (see Section 3.1. and 3.2. above) then it is accounted for at amortized cost or FVOCI, otherwise it is measured at FVTPL.
However, the existing requirements for embedded derivatives still apply to financial liabilities, and to contracts for assets that are not within the scope of IFRS 9.

Example 18 – Convertible note receivable: Difference between IAS 39 and IFRS 9

Entity A invests in a CU1,000 convertible note issued by Entity B. The convertible note pays a 5% annual coupon with a maturity of three years. At any point prior to its maturity, Entity A has the option to convert the note into 1,000 shares of Entity B.

The market interest rate for a similar instrument without the conversion feature would be 8%.

IAS 39	IFRS 9
The instrument contains: – Debt host contract – an annual coupon receivable of 5% and CU1,000 on maturity, and – Embedded equity option – option to buy shares at CU1. The equity option derivative is not closely related to the debt host contract. The entity therefore has two options: i. Bifurcate the instrument, that is: – Equity option at FVTPL – Host debt contract at amortised cost. ii. Designate entire contract at FVTPL.	No bifurcation, consider the instrument in its entirety: – The coupon rate is lower than the market interest rate, and therefore does not reflect the consideration for the time value of money and credit risk – Return is also linked to the value of the equity conversion. Therefore, the instrument fails the SPPI test for classification at amortised cost. Accordingly, the entity must account for the entire instrument at FVTPL.

Example 19 – Gold linked note receivable: Difference between IAS 39 and IFRS 9

Entity A invests CU1,000 in a debt instrument which pays a coupon that is based on the gold price (gold linked note). The note matures in three years and pays a coupon based on the market price for gold.

Question: How should Entity A account for the note under IAS 39 and IFRS 9?

IAS 39	IFRS 9
The instrument contains: – Debt host contract to receive CU1,000 in three years – Derivative that is based on the market price of gold which is not closely related to the debt host contract. The entity therefore has two options: i. Bifurcate the instrument, that is: – Gold linked derivative at FVTPL – Host debt contract at amortised cost. ii. Designate entire contract at FVTPL.	Consider the instrument in its entirety: – The coupon rate is linked to the value of the gold price and does not reflect the consideration for the time value of money and credit risk. Therefore, the instrument fails the SPPI test for classification at amortised cost. Accordingly, the entity must account for the entire instrument at FVTPL.

FINANCIAL LIABILITIES – CLASSIFICATION

The classification and measurement of financial liabilities in accordance with IFRS 9 *Financial Instruments* remains largely unchanged from IAS 39 *Financial Instruments: Recognition and Measurement*.

Financial liabilities are either classified as:

- Financial liabilities at amortized cost; or
- Financial liabilities as at fair value through profit or loss (FVTPL).

Financial liabilities are measured at amortized cost unless either:

- The financial liability is held for trading and is therefore required to be measured at FVTPL (e.g. derivatives not designated in a hedging relationship), or
- The entity elects to measure the financial liability at FVTPL (using the fair value option).

In contrast to financial assets, the existing requirements in IAS 39 for the separation of embedded derivatives have been continued for financial liabilities, meaning that financial liabilities to be measured at amortized cost would still need to be analyzed to determine whether they contain any embedded derivatives that are required to be accounted for separately at FVTPL.

Examples of financial liabilities that are likely to be classified and measured either at amortised cost or at FVTPL include:

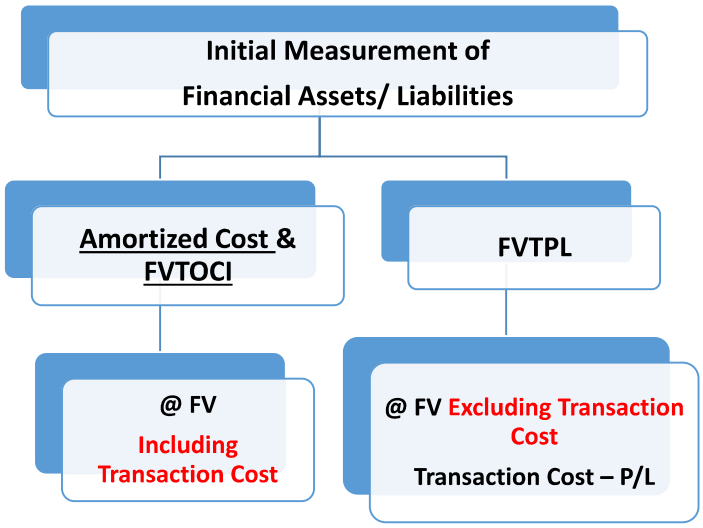
Amortised cost	FVTPL
– Trade payables – Loan payables with standard interest rates (such as a benchmark rate plus a margin) or the host contract arising from a loan agreement which contains separable embedded derivatives – Bank borrowings	– Interest rate swaps (not designated in a hedging relationship) – Commodity futures/option contracts (not designated in a hedging relationship) – Foreign exchange future/option contracts (not designated in a hedging relationship) – Convertible note liabilities designated at FVTPL – Contingent consideration payable that arises from one or more business combinations.

MEASUREMENT

Measurement on initial recognition

The requirements for the initial measurement of financial assets and liabilities under IFRS 9 *Financial Instruments* were carried forward from IAS 39 *Financial Instruments: Recognition and Measurement*.

At initial recognition a financial instruments is measured at fair value including transaction costs unless the financial instrument is carried at FVTPL, in which case the transaction costs are immediately recognized in profit or loss.



Note: The fair value is determined in accordance with IFRS 13 *Fair Value Measurement*.

Day one gains and losses

The best estimate of the fair value at initial recognition is usually the transaction price, represented by the fair value of the consideration given or received in exchange for the financial instrument.

Any difference between the fair value estimated by the entity and the transaction price is recognized:

- In profit or loss, if the estimate is evidenced by a quoted price in an active market; and
- Deferred as an adjustment to the carrying amount of the financial instrument in all other cases.

Note:

The new expected loss impairment model under IFRS 9 requires an entity to recognize 12-month expected credit losses for all financial assets (unless the exemption for trade/lease receivables or contract assets applies (see Section 5.2.1.). However, this adjustment does not represent a day one loss because the fair value is determined first, with credit losses then being deducted. IFRS 9 does not explicitly require the recognition of 12-month expected credit losses immediately after initial recognition, but an entity would need to recognize a loss all

Trade receivables

IFRS 9 provides an ***exception for the initial recognition of trade receivables*** without significant financing component to be ***recognized at the transaction price instead of fair value***. The existence of a significant financing component is determined in accordance with the guidance set out in paragraphs 60-65 of **IFRS 15 *Revenue from Contracts with Customers*.**

For trade receivables with a significant financing component, any differences arising from the revenue recognized based on the transaction price in accordance with IFRS 15 and the fair value of the trade receivable is recognized as an expense in profit or loss.

Note:

In practice, short-term receivables and payables with no stated interest rate would continue to be measured at their invoiced amount, because the effect of discounting is likely to be immaterial.

Transaction costs

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument.

Examples of transaction costs are: fees and commissions paid to agents, advisers, brokers and dealers; levies by regulatory agencies and securities exchanges; transfer taxes and duties; credit assessment fees; registration charges and similar costs.

Significant judgment maybe required to interpret the definition of transaction costs in practice. Cost that do not qualify as transaction costs are debt premiums or discounts, financing costs, internal administration costs and holding costs.

For all financial instruments that are not measured at FVTPL the treatment of transaction costs is made on an instrument-by-instrument basis and either increase (financial asset) or decrease (financial liability) the amount initially recognized in the financial statements.

All other transaction related costs that do not qualify as transaction costs are expensed as they are incurred.

Measurement after Recognition **(Subsequent measurement)**

Financial assets

After initial recognition, financial assets are either measured at amortized cost or at fair value. As with the initial recognition of financial instruments, the fair value is determined by applying the guidance set out in IFRS 13.

IFRS 9 removed the exception from IAS 39 to account for certain equity investments at cost from IAS 39 and requires entity's to measure equity investments at fair value. However, IFRS 9 states that in limited circumstances the cost is an appropriate estimate of the fair value, which may be situations where:

- The most recently available information is not sufficient to measure the fair value; or
- There is a wide range of possible fair value measurements and cost represents the best estimate within that range.

However, cost is never the best estimate for the fair value for quoted equity investments. Furthermore it was noted by the IASB that this exception would never apply to equity investments held by particular entities such as financial institutions and investment funds.

Financial liabilities – General requirements

For the purpose of subsequent measurement financial liabilities are either measured at amortized cost or at FVTPL in accordance with IFRS 13.

Financial liabilities at FVTPL – changes in own credit risk

In a major change from IAS 39 the new guidance under IFRS 9 requires when an entity designates a financial liability at FVTPL, the changes in fair value that relate to changes in the entity's own credit status are normally presented in other comprehensive income instead of profit or loss.

This is to eliminate the counter intuitive effect that would otherwise arise, that the poorer the financial condition of an entity, the higher the discount rate that will apply when measuring the fair value of its financial liability and the higher the associated gain will become that will be recognized in profit or loss.

This means that, under IFRS 9, entities will typically have to determine the change in fair value of the financial liability as a whole, and then perform a separate calculation to determine the change in fair value that is attributable to changes in their own credit status, and present those changes in other comprehensive income (OCI), while the remaining fair value changes will be presented in profit or loss.

The cumulative changes in fair value arising from changes in an entity's own credit status that is recognized in OCI are not subsequently recycled to profit or loss when the financial liability is derecognized. However, IFRS 9 permits entities to transfer the amount within equity after Derecognition of the financial liability.

An entity determines the amount of the fair value change attributable to changes in its own credit risk either:

- ✓ As the amount of the change in the fair value that is not attributable to changes in market conditions that give rise to market risk, which includes changes in: Benchmark interest rates
  Prices of other financial instruments
  Commodity prices
  Foreign exchange rates
  Index of prices and rates.

- ✓ Using another method if that method more faithfully represents the related portion of the change in fair value.

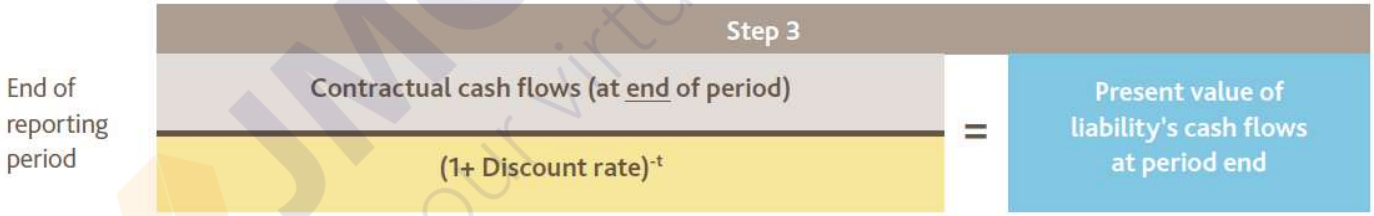
If the only significant relevant changes in market conditions are due to changes in an observed benchmark interest rate, the amount attributable to changes in an entity's own credit risk can be estimated using the default method, which is based on the calculation of the financial instrument's internal rate of return (IRR).

Note: *The benchmark interest rate is not explicitly defined by IFRS 9. However, usually the benchmark interest rate is a risk-free rate which excludes all changes which are due to changes in an entity's own credit risk. Examples of benchmark rates are interbank rates such as LIBOR or EURIBOR.*

amount of the fair value change attributable to changes in its own credit risk ……..

In the first step, the entity computes the liability's IRR at the start of the reporting period using the fair value of the liability and the liability's contractual cash flows at the start of the reporting period. It deducts from the IRR the observed benchmark interest rate at the start of the period. The result is an instrument specific IRR.

Secondly, the entity derives the discount rate, which is the sum of the instrument specific IRR (calculated in Step 1) and the benchmark interest rate at the end of the reporting period, in order to calculate the present value of the contractual cash flows.



In the third step, the entity determines the present value of the contractual cash flows of the liability at the end of the reporting period, using the discount rate derived in Step 2.

Finally, the entity deducts the present value of the liability's cash flows at the period end as determined under Step 3) from the fair value of the financial liability at the end of the reporting period. The result is the change in the fair value of the financial liability attributable to an entity's own credit risk.

Example 20 – Recognising fair value changes due to changes in own credit risk

Entity A issued a bond under conditions that qualify for the fair value option in IFRS 9, and decided to designate the liability to be accounted for at fair value through profit or loss (FVTPL). At the end of the financial reporting period, Entity A determines that CU2 of the change in the fair value of the bond of CU10 is due to a change in Entity A's credit risk.

Question: How should Entity A account for the fair value change?

Dr		Financial liability (Bond)	CU10	
	Cr	OCI		CU2
	Cr	Profit or loss		CU8

Amortized cost measurement

Amortized cost is defined in IFRS 9 as the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the ***effective interest method*** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

Example 21 – Calculating the effective interest rate

Entity A acquires a debt instrument with a nominal value of CU100 at the beginning of year 20X1 for CU90. Transaction costs in relation to the acquisition are CU8. The instrument bears a 5% coupon, which is paid out annually. The instrument matures in five years at the end of 20X5.

Entity A accounts for the debt instrument at amortized cost.

Question: How does entity A calculate the effective interest rate?

Answer: The internal rate of return (IRR) of the cash flows is the interest rate that discounts the expected cash flows to the initial carrying amount of CU98. The IRR is calculated using the following formula:

Revisions of estimates of cash flows

For revisions of estimates of cash flows for floating rate financial assets and floating rate financial liabilities with variable market rate of interest, the re-estimation of the cash flows driven by the movements in the market rate of interest will affect and change the effective interest rate. However, the re-estimation of the cash flows does normally not significantly affect the carrying amount of the asset or liability. For practical reasons, the carrying amount is therefore typically not updated at each reporting date.

This is different from the accounting for a change in the estimated cash flows for financial instruments with either:
A fixed rate of interest or
A variable rate that does not represent a market rate (such as LIBOR).

Examples of such instruments include loans with interest payments linked to future revenue, production output, or profit. In this case the entity recalculates the carrying amount by computing the present value of the estimated future cash flows at the financial instrument's original effective interest rate. The resulting adjustment to the carrying amount is recognized as a gain or loss in profit or loss.

Example 22 – Adjustment of the carrying amount of a loan with interest linked to EBITDA

On 1 January 20X5, Entity A takes out a loan with Entity B for CU1,000 for three years. The interest payments on the loan are 10% of Entity A's EBITDA. On 1 January 20X5, Entity A expects the following EBITDA figures.

Year	EBITDA	10% of EBITDA
31/12/20X5	CU1,000	CU100
31/12/20X6	CU2,500	CU250
31/12/20X7	CU3,000	CU300

Questions: (a) What is Entity A's initial journal entry on 1 January 20X5?
(b) What is the effective interest rate of the loan?
(c) What are Entity A's journal entries at 31 December 20X5?

Effective interest rate for floating rate instruments

For floating rate instruments the effective interest rate is required to be updated for when cash flows are re-adjusted for changes in the market rate of interest. In line with current practice under IAS 39, two approaches are usually applied in practice to calculate the effective interest rate:

- Using the actual benchmark interest rate set for the relevant period; or
- Taking into account expectations about future interest rates and changes in the expectations.

Example 23 – Calculating the effective interest rate for floating rate instruments

Entity A issues a debt instrument at a principal amount outstanding of CU100 at the beginning of 20X1, which matures in three years (20X3). The coupon rate of the instrument is defined as 12-month LIBOR plus 2%.

The 12-month LIBOR at initial recognition is 2% and expected to be 3% in 20X2 and 4% in 20X3.

Question: How is the effective interest rate for the floating rate instrument calculated?

As with the guidance under IAS 39, there are two options to calculate the effective interest rate for floating rate debt under IFRS 9.

Actual benchmark interest rate for the period	Expectations about future interest rates
The initial effective interest rate is 4% Being the 12-month LIBOR at 2% + 2%.	The initial effective interest rate is approx. 5% Being the internal rate of return of: – The expected coupons to be received (CU4, CU5, CU6) and – The principal amount repayable at maturity of CU100.

Modifications of financial assets and financial liabilities

For financial assets that are modified, IFRS 9 includes new guidance for the measurement of the amortized cost of modified financial assets where the modification did not result in derecognition.

For a modification that does not result in derecognition, the difference between the present value of the modified cash flows discounted using the original effective interest rate and the present value of the original cash flows, is recognized in profit or loss as a gain or loss from modification. Costs or fees in relation to the modification of the financial asset are recognized as part of the carrying amount of the asset and amortized over the remaining term of the instrument.

A modification of the original financial asset that results in the derecognition of the financial asset, requires the recognition of the new modified financial asset in line with the general requirements for the initial recognition (i.e. at fair value plus transaction costs). However, IFRS 9 does not include guidance to determine which costs and fees may be eligible for capitalisation, rather than being amounts which should be attributed to the derecognition of the old debt and therefore expensed immediately.

IMPAIRMENT

The following financial instruments are included within the scope of the impairment requirements in IFRS 9 *Financial Instruments*:

- Debt instruments measured at amortised cost, e.g.
  - Trade receivables,
  - Loans receivable from related parties or key management personnel,
  - Deferred consideration receivable, and
  - Intercompany loans in separate financial statements.
- Debt instruments that are measured at fair value through other comprehensive income (FVOCI)
- Loan commitments (except those measured at FVTPL)
- Financial guarantee contracts (except those measured at FVTPL)
- Lease receivables within the scope of IAS 17 *Leases*
- Contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers*
- Receivables arising from transactions within the scope of IAS 18 *Revenue* and IAS 11 *Construction Contracts* (if adoption of IFRS 9 is before the adoption of IFRS 15).

Overview of the new impairment model

IFRS 9 establishes a three stage impairment model, based on whether there has been a significant increase in the credit risk of a financial asset since its initial recognition. These three stages then determine the amount of impairment to be recognized as expected credit losses (ECL) (as well as the amount of interest revenue to be recorded) at each reporting date:

– **Stage 1**: Credit risk has not increased significantly since initial recognition – recognize 12 months ECL, and recognize interest on a gross basis

– **Stage 2**: Credit risk has increased significantly since initial recognition – recognize lifetime ECL, and recognize interest on a gross basis

– **Stage 3**: Financial asset is credit impaired (using the criteria currently included in IAS 39 *Financial Instruments: Recognition and Measurement*) – recognize lifetime ECL, and present interest on a net basis (i.e. on the gross carrying amount less credit allowance).

The recognition of impairment (and interest revenue) is summarised below:

However as a practical expedient, a simplified model applies for:

Trade receivables with maturities of less than 12 months ; and Other long term trade and lease receivables

In estimating expected credit losses, entities must consider a range of possible outcomes and not the 'most likely' outcome. The standard requires that at a minimum, entities must consider the probability that:

A credit loss occurs and

No credit loss occurs.

Recognition of impairment – 12-month expected credit losses

12-month expected credit losses are calculated by multiplying the probability of a default occurring in the next 12 months with the total (lifetime) expected credit losses that would result from that default, regardless of when those losses occur. Therefore, 12-month expected credit losses represent a financial asset's lifetime expected credit losses that are expected to arise from default events that are possible within the 12 month period following origination of an asset, or from each reporting date for those assets in **Stage 1**.

Note: The distinction between 12-month expected credit losses to be calculated in accordance with IFRS 9 and the cash shortfalls that are anticipated to arise over the next 12 months is important. As an example, the death of a credit card borrower does lead, in a number of cases, to the outstanding balance becoming impaired. Linking this to the accounting requirements, the IFRS 9 model therefore requires the prediction on initial recognition (and at each reporting date) of the likelihood of the borrower dying in the next 12 months and hence triggering an impairment event. Given the very large number of balances, it is likely that this would be calculated on a portfolio basis and not for each individual balance.

Example 01: portfolio of mortgages and personal loans

Credito Bank operates in South Zone, a region in which clothing manufacture is a significant industry.
The bank provides personal loans and mortgages in the region. The average loan to value ratio for all its mortgage loans is 75%. All loan applicants are required to provide information regarding the industry in which they are employed. If the application is for a mortgage, the customer must provide the postcode of the property which is to serve as collateral for the mortgage loan.
Credito Bank applies the expected credit loss impairment model in IFRS 9 Financial instruments. The bank tracks the probability of customer default by reference to overdue status records. In addition, it is required to consider forward-looking information as far as that information is available.
Credito Bank has become aware that a number of clothing manufacturers are losing revenue and profits as a result of competition from abroad, and that several are expected to close.

Required How should Credito Bank apply IFRS 9 to its portfolio of mortgages in the light of the changing situation in the clothing industry?

Solution
Credito Bank should segment the mortgage portfolio to identify borrowers who are employed by suppliers and service providers to the clothing manufacturers. This segment of the portfolio may be regarded as being 'in Stage 2', that is having a significant increase in credit risk. Lifetime credit losses must be recognised. In estimating lifetime credit losses for the mortgage loans portfolio, Credito Bank will take into account amounts that will be recovered from the sale of the property used as collateral. This may mean that the lifetime credit losses on the mortgages are very small even though the loans are in Stage 2.

Later in the year, more information emerged, and Credito Bank was able to identify the particular loans that defaulted or were about to default.

Required How should Credito Bank treat these loans?

Answer

The loans are now in Stage 3. Lifetime credit losses should continue to be recognised, and interest revenue should switch to a net interest basis, that is on the carrying amount net of allowance for credit losses.

Example 02

Debita Bank applies the expected credit loss impairment model of IFRS 9. At 30 September 20X4, the bank approved a total of $10 million overdraft facilities which have not yet been drawn. Debita Bank considers that $8 million is in Stage 1 (ie, no significant increase in credit risk). Of that $8 million in Stage 1, $4 million is expected to be drawn down within the next 12 months, with a 3% probability of default over the next 12 months. Debita Bank considers that $2 million is in Stage 2 and $2 million is expected be drawn down over the remaining life of the facilities, with a probability of default of 10%.

Required

Calculate the additional allowance required in respect of the undrawn overdraft facilities, taking account of the above information.

Answer

Stage	Expected credit loss
	$
Stage 1 $4 million × 3%	120,000
Stage 2 $2 million × 10%	200,000
	320,000

Under the IFRS 9 model, Debita bank would recognise an additional allowance of $320,000 for the undrawn portion of its overdraft facilities.

Example 03 : trade receivable provision matrix

On 1 June 20X4, Kredco sold goods on credit to Detco for $200,000. Detco has a credit limit with Kredco of 60 days. Kredco applies IFRS 9, and uses a pre-determined matrix for the calculation of allowances for receivables as follows.

Days overdue	Expected loss provision
Nil	1%
1 to 30	5%
31 to 60	15%
61 to 90	20%
90 +	25%

Detco had not paid by 31 July 20X4, and so failed to comply with its credit term, and Kredco learned that Detco was having serious cash flow difficulties due to a loss of a key customer. The finance controller of Detco has informed Kredco that they will receive payment. Ignore sales tax.

Required

Show the accounting entries on 1 June 20X4 and 31 July 20X4 to record the above, in accordance with the expected credit loss model in IFRS 9.

On 1 June 20X4

The entries in the books of Kredco will be:

DEBIT	Trade receivables	$200,000	
CREDIT	Revenue		$200,000

Being initial recognition of sales

An expected credit loss allowance, based on the matrix above, would be calculated as follows:

DEBIT	Expected credit losses	$2,000	
CREDIT	Allowance for receivables		$2,000

Being expected credit loss: $200,000 × 1%

On 31 July 20X4

Applying Kredco's matrix, Detco has moved into the 5% bracket, because it has exhausted its 60-day credit limit. (Note that this does not equate to being 60 days overdue!) Despite assurances that Kredco will receive payment, the company should still increase its credit loss allowance to reflect the increased credit risk. Kredco will therefore record the following entries on 31 July 20X4

DEBIT	Expected credit losses	$8,000	
CREDIT	Allowance for receivables		$8,000

Being expected credit loss: $200,000 × 5% – $2,000