IFRS 9 – FINANCIAL INSTRUMENTS

(replaces IAS 39 with mandatory application from 01.01.2018)

FINANCIAL ASSETS

Initial Measurement

- All financial assets are initially measured at fair value.
- Transaction costs are capitalised, except financial assets at FVTPL, which are expensed.

Subsequent Measurement

- Based on the classification of the financial asset.

Classification

Debt Instruments

Debt instruments are classified in three categories based on the business model test and SPPI test (Solely Payment of Principal and Interest):

- Fair Value Through Profit or Loss
- Fair Value Through Other Comprehensive Income
- Amortised Cost

Principal is the fair value of the financial asset at initial recognition.

Interest is consideration for the time value of money, the credit risk, other basic lending risks and a profit margin.
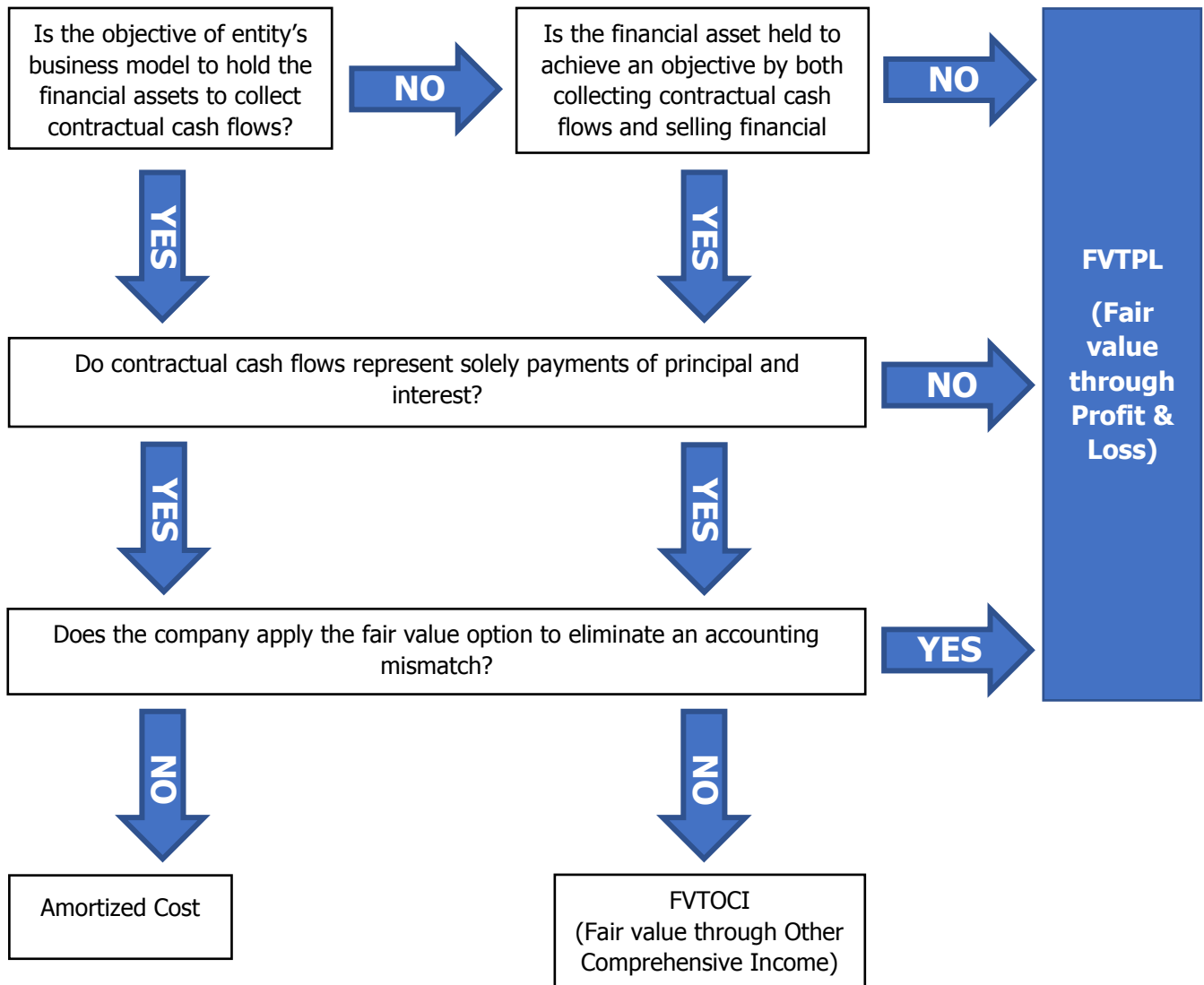
Categories explanation

1. **FVTPL**:

    - Initially recognised at fair value
    - Revalued to fair value each year end
    - Gains and losses go to P&L
    - Transaction costs go to P&L

2. **FVTOCI**:

    - Initially recognised at fair value plus transaction costs
    - Revalued to fair value each year end
    - Gains and losses go to OCI
    - Interest income is calculated using the Effective Interest Rate (EIR) same as Amortised Cost
    - On derecognition the FV reserve goes to P&L
    - Foreign exchange differences go to P&L

The following table illustrates the method used for the classification of debt instruments:

Is the objective of entity's business model to hold the financial assets to collect contractual cash flows?	**NO** →	Is the financial asset held to achieve an objective by both collecting contractual cash flows and selling financial	**NO** →	
YES ↓		**YES** ↓		**FVTPL** **(Fair value through Profit & Loss)**
Do contractual cash flows represent solely payments of principal and interest?			**NO** →	
YES ↓		**YES** ↓		
Does the company apply the fair value option to eliminate an accounting mismatch?			**YES** →	
NO ↓		**NO** ↓		
Amortized Cost		FVTOCI (Fair value through Other Comprehensive Income)		

3. **Amortised Cost**:

- Initially recognised at fair value plus transaction costs
- Interest income is calculated using the Effective Interest Rate (EIR)
- EIR is the discount rate that will give a present value of future cash flows

Example:

Year	Opening balance	Interest income EIR = 10%	Cash received Coupon = 8%	Closing balance
Y1	5,000	500	(400)	5,100
Y2	5,100	510	(400)	5,210
Y3	5,210	521	(400)	-
			(5,331)	

P&L   SFP

Equity Instruments

- Equity Instruments held for trading ⟶ **FVTPL**
- Equity Instruments not held for trading (or irrevocable election) ⟶ **FVTPL**
    - On derecognition the FV Reserve goes to Retained Earnings
    - Foreign exchange differences go to OCI

Unquoted Equity Instruments

- No cost option. Measured at fair value
- Entities need to develop an estimate of fair value for their unquoted Equity Instruments

Embedded Derivatives

- IFRS 9 has eliminated the requirement to separately account for embedded derivatives for financial assets
- It requires entities to asses the hybrid contract (as a whole) for classification
- The existing requirements for embedded derivatives still apply to financial liabilities

FINANCIAL LIABILITIES

Initial Measurement

- All financial liabilities are initially measured at fair value
- Transaction costs are capitalised, except financial liabilities at FVTPL, which are expensed

Subsequent Measurement

- Based on the classification of the financial liability

Debt Instruments

- Financial Liabilities held for trading ⟶ **FVTPL**
- All other Financial Liabilities ⟶ **AC** *(unless FV option* is applied)*

*Fair Value option: Made on initial recognition and not reassess
- FV change due to own credit risk ⟶ **Presented in OCI**
- Remaining FV change ⟶ **Presented in P&L**
- Amounts presented in OCI shall not be subsequently transferred to P&L

FVTPL

If FV can not be observed from an active market, calculate by discounting the future cash flows at a market rate of interest.

Example:

Date	Cash flow	Discount rate (10%)	Present Value
31/12/Y1	500,000	$1/1.10$	454,545
31/12/Y2	10,500,000	$1/1.10^2$	8,677,686
			9,132.231

FV

Reclassifications:

IFRS 9 does not allow reclassification:

- For equity investments held for trading that are measured at FVTOCI (irrevocable election)
- Where the Fair Value option has been exercised in any circumstance for a financial asset or financial liability

IMPAIRMENT

IFRS 9 goes from incurred loss model to Expected Credit Losses model (ECL).

Estimates of ECL must reflect reasonable and supportable information that is available without undue cost or effort.

Potential data sources:

- Internal historical credit loss experience
- Internal and external ratings
- Credit loss experience of other entities
- External reports and statistics

Three stage impairment model

There are three stages that determine the amount of impairment to be recognised as ECL, as well as the amount of interest revenue.

Stage	1	2	3
Impairment	12-month ECL	Lifetime ECL	
Interest	Effective interest on the gross carrying amount (before deducting ECL)		Effective interest on the net (carrying) amount

Stage 1:
- Credit risk has not increased significantly since initial recognition
- Recognise 12-month ECL
- Interest revenue calculated on the gross amount

Stage 2:
- Credit risk has increased significantly since initial recognition
- Recognise lifetime ECL
- Interest revenue calculated on the gross amount

Stage 3:
- There is objective evidence of impairment as at the reporting date
- Recognise lifetime ECL
- Interest revenue calculated on the net amount

Transition between stages

A significant increase in credit risk can include:

- Changes in general economic/market conditions
- Significant changes in the operating results/financial position of the borrower
- Expected or potential breaches of covenants
- Expected delay in payment

Indicators that an asset is credit impaired:

- Actual breach of contract
- Probable that the borrower will enter bankruptcy or other financial reorganisation

In certain circumstances, qualitative and non-statistical quantitative information may be sufficient to determine that a financial instrument has met the criteria for the recognition of lifetime ECL.

Regardless of the way in which an entity assesses significant increases in credit risk, there is rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

An entity can rebut this presumption if it has information that demonstrates that the credit risk has not increased significantly.

To assess significant increases in credit risk on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics.

The aggregation of financial instruments to assess whether there are changes in credit risk on a collective basis, may change over time as new information becomes available.

Recognition of impairment

12-month ECL: Cash flows receivable x PD X LGD = X ⟶ **Discounted using EIR**

Lifetime ECL: (Cash flows receivable/EIR) x PD x LGD = X

PD: Probability of Default rate

LGD: Loss Given Default rate. Estimate of the loss arising on default

Calculating EIR

The EIR is calculated at initial recognition of a financial asset or a financial liability.

It is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to:

- The gross carrying amount of the financial asset; or
- The amortised cost of the financial liability

The estimate of expected cash flows considers all contractual terms but does not consider ECL.

For floating rate financial instruments, the EIR is altered by periodic re-estimations of cash flows to reflect movements in market rates of interest.

Purchased credit-impaired financial assets

A financial asset that there is evidence of impairment at the point of initial recognition.

Interest income on such assets, is calculated using the credit-adjusted EIR.

The rate incorporates all the contractual terms of the financial assets as well as ECL.

Revolving credit facilities

Certain financial instruments include both a loan and an undrawn commitment component.

For such financial instruments, the entity shall measure ECL over the period that the entity is exposed to credit risk. This applies to both drawn and undrawn amounts (estimate the expected portion that will be drawn down over the expected life of the loan commitment).

Modified financial assets

For modifications that do not result in derecognition, the gross carrying amount of the asset is recalculated by discounting the modified contractual cash flows using the EIR before modification.

Any difference between this recalculated amount and the existing gross carrying amount is recognised in P&L as modification gain/loss.

Any costs incurred for the modification, adjust the carrying amount of modified financial asset and is amortised over the remaining term of the modified financial asset.

A financial asset that has been renegotiated or modified, is not automatically considered to have lower credit risk.

Simplified impairment model

1. **Trade receivables and contract assets without significant financial components**

   - Current receivables, 12-month and lifetime ECL would be the same
   - Calculate ECL using a provision matrix
   - Update their historical provision rates with current and forward-looking estimates

2. **Other long-term trade receivables, contract assets and lease receivables. Can choose between**:

- General three-stage approach ⟶ **Monitor significant increases in credit risk**
- Simplified approach ⟶ **Lifetime ECL**

Presentation of ECL in the financial statements

- An entity recognises ECL as a loss allowance in the SFP.
- It is not required to present the loss allowance as a separate line item in the SFP. The carrying amount is stated net of ECL
- No loss allowance is recognised in the SFP in respect of debt instruments that are measured at FVTOCI, because the carrying amount of these assets is their fair value. However, disclosures have to be provided about the loss allowance amount.

- The following line items need to be presented in P&L or OCI:
    - Revenue, presenting separately interest revenue calculated using EIR
    - Gains/losses arising on derecognition of financial assets measured at AC
    - Impairment losses (including reversals)
    - Gains/losses on reclassifications of financial assets from AC to FVTPL
    - Reclassification of gains/losses from OCI to P&L for assets reclassified from FVTOCI to FVTPL

Disclosures

Generally, most important *Quantitative* disclosures:

- Reconciliation of loss allowance accounts showing key drivers for change
- Explanation of gross carrying amounts showing key drivers for change
- Gross carrying amount per credit risk grade
- Write-offs, recoveries and modifications
- Quantitative information about the collateral held as security and other credit enhancements

Generally, most important *Qualitative* disclosures

- Inputs, assumptions and techniques used to:
    - Estimate ECL
    - Determine 'significant increase in credit risk' and the entity's definition of default
    - Determine credit-impaired assets
    - Write-off policies
    - Policies regarding the modification of contractual cash flows of financial assets
    - A narrative description of collateral held as security and other credit enhancements

Application

Application is **retrospective** but there is an **exemption** not to restate the comparatives, by calculating the ECL as at the beginning of the reporting period and recognise the ECL in SFP and Reserves. Then the ECL is calculated at the end of the reporting period and recognised in SFP and P&L.

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