

IFRS AT A GLANCE  
IFRS 9 *Financial Instruments*





# IFRS 9 *Financial Instruments*

## BACKGROUND (PROJECT TO REPLACE IAS 39)

IFRS 9 introduces a single classification and measurement model for financial assets, dependent on both:

- The entity's business model objective for managing financial assets
- The contractual cash flow characteristics of financial assets.

IFRS 9 removes the requirement to separate embedded derivatives from financial asset host contracts (it instead requires a hybrid contract to be classified in its entirety at either amortised cost or fair value.)

Separation of embedded derivatives has been retained for financial liabilities (subject to criteria being met).

## INITIAL RECOGNITION AND MEASUREMENT (FINANCIAL ASSETS AND FINANCIAL LIABILITIES)

### Initial Recognition

When the entity becomes party to the contractual provisions of the instrument.

### Initial Measurement

At fair value, plus for those financial assets and liabilities not classified at fair value through profit or loss, directly attributable transaction costs.

- Fair value - is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date
- Directly attributable transaction costs - incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.

## FINANCIAL ASSETS - SUBSEQUENT CLASSIFICATION AND MEASUREMENT

Financial Assets are classified as either: (1) Amortised cost, (2) Fair value through profit or loss, (3) Fair Value through other comprehensive income

### (1) Amortised cost

#### Category classification criteria

Both of the below conditions must be met:

- Business model objective: financial assets held in order to collect contractual cash flows
- Contractual cash flow characteristics: solely payments of principal and interest on the principal amount outstanding.

#### Subsequent measurement

- Amortised cost using the effective interest method.

#### (i) Business model assessment

Based on the overall business, **not** instrument-by-instrument

Centres on whether financial assets are held to collect contractual cash flows:

- How the entity is run
- The objective of the business model as determined by key management personnel (KMP) (per IAS 24 *Related Party Disclosures*).

Financial assets do not have to be held to contractual maturity in order to be deemed to be held to collect contractual cash flows, but the overall approach must be consistent with 'hold to collect'.

#### (ii) Contractual cash flow assessment

Based on an instrument-by-instrument basis

Financial assets with cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.

Interest is consideration for **only** the time-value of money and credit risk.

FOREX financial assets: assessment is made in the denomination currency (i.e. FX movements are not taken into account).

IFRS 9 contains various illustrative examples in the application of both the (i) Business Model Assessment and (ii) Contractual Cash Flow Characteristics.

### (3) Fair value through other comprehensive income

#### Equity Instruments

Note: Designation at initial recognition is **optional** and **irrevocable**.

#### Category classification criteria

- Available **only** for investments in equity instruments (within the scope of IFRS 9) that are **not** held for trading.

#### Subsequent measurement

- Fair value, with all gains and losses recognised in other comprehensive income
- Changes in fair value are not subsequently recycled to profit and loss
- Dividends are recognised in profit or loss.

#### Debt Instruments

#### Category classification criteria

- meets the SPPI contractual cash flow characteristics test (see box (1)(ii) above)
- Entity holds the instrument to collect contractual cash flows and to sell the financial assets

#### Subsequent measurement

- Fair value, with all gains and losses (other than those relating to impairment, which are included in profit or loss) being recognised in other comprehensive income
- Changes in fair value recorded in other comprehensive income are recycled to profit or loss on derecognition or reclassification.

### (2) Fair value through profit or loss

#### Category classification criteria

- Financial assets that do not meet the amortised cost criteria
- Financial assets designated at initial recognition. The option to designate is available:
  - If doing so eliminates, or significantly reduces, a measurement or recognition inconsistency (i.e. 'accounting mismatch').

Note: the option to designate is **irrevocable**.

#### Subsequent measurement

- Fair value, with all gains and losses recognised in profit or loss.

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## IMPAIRMENT OF FINANCIAL ASSETS

<p><u>Scope</u></p> <p>The impairment requirements are applied to:</p> <ul style="list-style-type: none"> <li>Financial assets measured at amortised cost (incl. trade receivables)</li> <li>Financial assets measured at fair value through OCI</li> <li>Loan commitments and financial guarantees contracts where losses are currently accounted for under IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i></li> <li>Lease receivables.</li> </ul> <p>The impairment model follows a three-stage approach based on changes in expected credit losses of a financial instrument that determine</p> <ul style="list-style-type: none"> <li>the recognition of impairment, and</li> <li>the recognition of interest revenue.</li> </ul>	<p><u>Initial recognition</u></p> <p>At initial recognition of the financial asset an entity recognises a loss allowance equal to 12 months expected credit losses which consist of expected credit losses from default events possible within 12 months from the entity's reporting date. An exception is purchased or originated credit impaired financial assets.</p> <p><u>Subsequent measurement</u></p> <table border="1"> <thead> <tr> <th>Stage</th> <th>1</th> <th>2</th> <th>3</th> </tr> </thead> <tbody> <tr> <td>Impairment</td> <td>12 month expected credit loss</td> <td colspan="2">Lifetime expected credit loss</td> </tr> <tr> <td>Interest</td> <td colspan="2">Effective interest on the gross carrying amount (before deducting expected losses)</td> <td>Effective interest on the net (carrying) amount</td> </tr> </tbody> </table>	Stage	1	2	3	Impairment	12 month expected credit loss	Lifetime expected credit loss		Interest	Effective interest on the gross carrying amount (before deducting expected losses)		Effective interest on the net (carrying) amount
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## THREE-STAGE APPROACH

STAGE 1	STAGE 2	STAGE 3
<p><u>12 month expected credit losses (gross interest)</u></p> <ul style="list-style-type: none"> <li>Applicable when no significant increase in credit risk</li> <li>Entities continue to recognise 12 month expected losses that are updated at each reporting date</li> <li>Presentation of interest on gross basis</li> </ul>	<p><u>Lifetime expected credit losses (gross interest)</u></p> <ul style="list-style-type: none"> <li>Applicable in case of significant increase in credit risk</li> <li>Recognition of lifetime expected losses</li> <li>Presentation of interest on gross basis</li> </ul>	<p><u>Lifetime expected credit losses (net interest)</u></p> <ul style="list-style-type: none"> <li>Applicable in case of credit impairment</li> <li>Recognition of lifetime expected losses</li> <li>Presentation of interest on a net basis</li> </ul>

## PRACTICAL EXPEDIENTS

<p><u>30 days past due rebuttable presumption</u></p> <ul style="list-style-type: none"> <li>Rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due</li> <li>When payments are 30 days past due, a financial asset is considered to be in stage 2 and lifetime expected credit losses would be recognised</li> <li>An entity can rebut this presumption when it has reasonable and supportable information available that demonstrates that even if payments are 30 days or more past due, it does not represent a significant increase in the credit risk of a financial instrument.</li> </ul>	<p><u>Low credit risk instruments</u></p> <ul style="list-style-type: none"> <li>Instruments that have a low risk of default and the counterparties have a strong capacity to repay (e.g. financial instruments that are of investment grade)</li> <li>Instruments would remain in stage 1, and only 12 month expected credit losses would be provided.</li> </ul>
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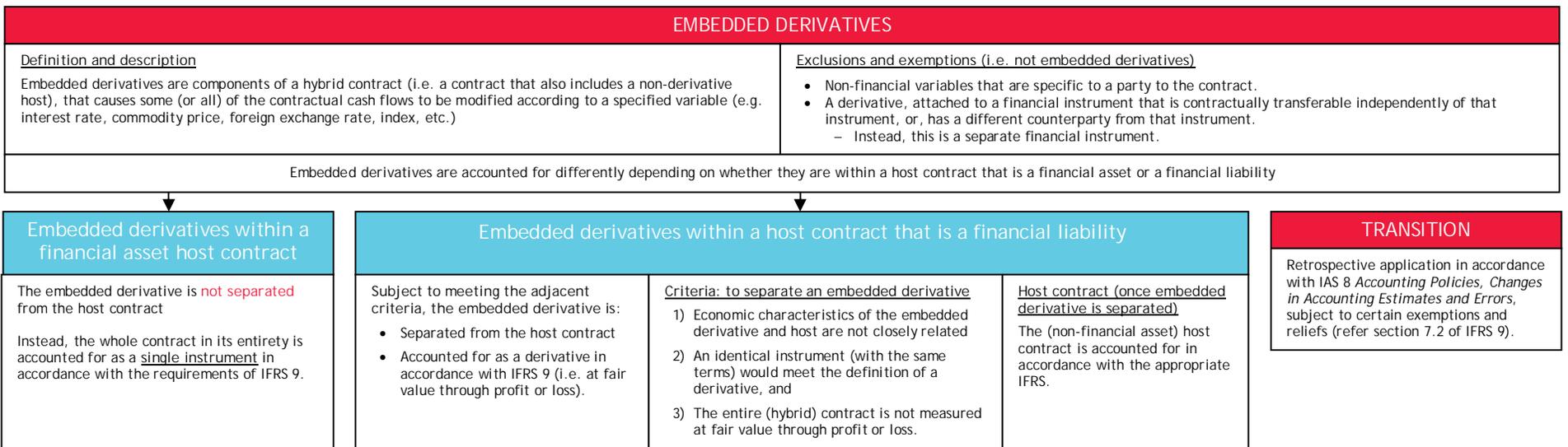
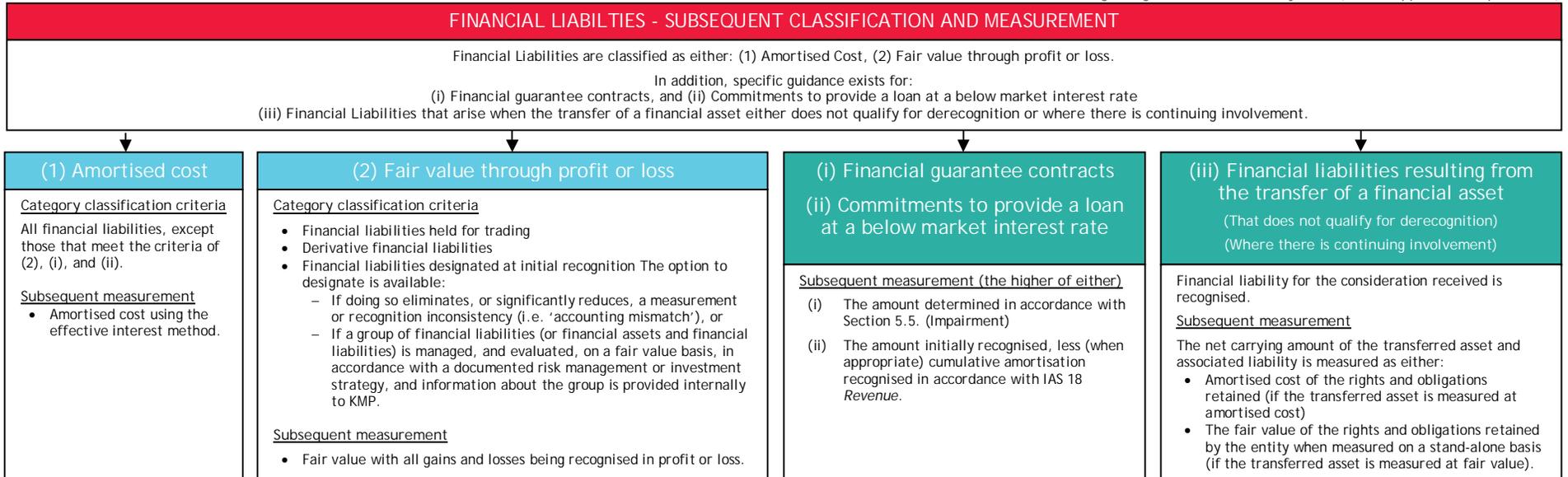
## SIMPLIFIED APPROACH

<p><u>Short term trade receivables</u></p> <ul style="list-style-type: none"> <li>Recognition of only 'lifetime expected credit losses' (i.e. stage 2)</li> <li>Expected credit losses on trade receivables can be calculated using provision matrix (e.g. geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer)</li> <li>Entities will need to adjust the historical provision rates to reflect relevant information about current conditions and reasonable and supportable forecasts about future expectations.</li> </ul> <p><u>Long term trade receivables and lease receivables</u></p> <p>Entities have a choice to either apply:</p> <ul style="list-style-type: none"> <li>the three-stage expected credit loss model; or</li> <li>the 'simplified approach' where only lifetime expected credit losses are recognised.</li> </ul>
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## LOAN COMMITMENTS AND FINANCIAL GUARANTEES

<ul style="list-style-type: none"> <li>The three-stage expected credit loss model also applies to these off balance sheet financial commitments</li> <li>An entity considers the expected portion of a loan commitment that will be drawn down within the next 12 months when estimating 12 month expected credit losses (stage 1), and the expected portion of the loan commitment that will be drawn down over the remaining life the loan commitment (stage 2)</li> <li>For loan commitments that are managed on a collective basis an entity estimates expected credit losses over the period until the entity has the practical ability to withdraw the loan commitment.</li> </ul>
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## DERECOGNITION

### FINANCIAL ASSETS

Consolidate all subsidiaries (including special purpose entities (SPEs)).

Determine whether the derecognition principles below are applied to all or part of the asset.

Have the rights to the cash flows from the asset expired?

YES

Derecognise the asset

NO

Has the entity transferred its rights to receive the cash flows from the asset?

NO

Has the entity assumed an obligation to pay the cash flows from the asset that meets the conditions in IFRS 9 paragraph 3.2.5?

NO

Continue to recognise the asset

YES

Has the entity transferred substantially all risks and rewards?

YES

Derecognise the asset

NO

Has the entity retained substantially all risks and rewards?

YES

Continue to recognise the asset

NO

Has the entity retained control of the asset?

NO

Derecognise the asset

YES

Continue to recognise asset to the extent of the entity's continuing involvement.

### FINANCIAL LIABILITIES

- A financial liability is derecognised only when extinguished - i.e., when the obligation specified in the contract is discharged, cancelled or it expires
- An exchange between an existing borrower and lender of debt instruments with substantially different terms or substantial modification of the terms of an existing financial liability of part thereof is accounted for as an extinguishment
- The difference between the carrying amount of a financial liability extinguished or transferred to a 3<sup>rd</sup> party and the consideration paid is recognised in profit or loss.

- If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it recognises either a servicing asset or liability for that servicing contract
- If, as a result of a transfer, a financial asset is derecognised, but the entity obtains a new financial asset or assumes a new financial liability or servicing liability, the entity recognises the new financial asset, financial liability or servicing liability at fair value
- On derecognition of a financial asset, the difference between the carrying amount and the sum of (i) the consideration received and (ii) any cumulative gain or loss that was recognised directly in equity is recognised in profit or loss.

- IFRS 9 paragraph 3.2.5 - where an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay those cash flows to one or more entities, three conditions need to be met before an entity can consider the additional derecognition criteria:
- The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset
  - The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients
  - The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. The entity is not entitled to reinvest the cash flows except for the short period between collection and remittance to the eventual recipients. Any interest earned thereon is remitted to the eventual recipients.

# IFRS 9 *Financial Instruments*

**CRITERIA TO APPLY HEDGE ACCOUNTING (ALL CRITERIA MUST BE MET)**

<p><b>(i) Hedging Relationship</b></p> <p>Must consist of:</p> <ul style="list-style-type: none"> <li>Eligible hedging instruments</li> <li>Eligible hedged items.</li> </ul>	<p><b>(ii) Designation and Documentation</b></p> <p>Must be formalised at the inception of the hedging relationship:</p> <ul style="list-style-type: none"> <li>The hedging relationship</li> <li>Risk management strategy and objective for undertaking the hedge</li> <li>The hedged item and hedging instrument</li> <li>How hedge effectiveness will be assessed.</li> </ul>	<p><b>(iii) All three hedge effectiveness requirements met</b></p> <p>(a) An economic relationship exists between the hedged item and hedging instrument</p> <p>(b) Credit risk does not dominate changes in value</p> <p>(c) The hedge ratio is the same for both the:</p> <ul style="list-style-type: none"> <li>Hedging relationship</li> <li>Quantity of the hedged item actually hedged, and the quantity of the hedging instrument used to hedge it.</li> </ul>
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**ELIGIBLE HEDGING INSTRUMENTS**

<p>Only those with from contracts with EXTERNAL parties of the entity (or group), that are:</p>	
<p><b>Derivatives</b> measured at fair value through profit or loss (FVTPL).</p> <p>Note: this excludes written options unless they are designated as an offset to a purchased option.</p>	<p><b>Non-derivatives</b> measured at fair value through profit or loss (FVTPL).</p> <p>Note: this excludes FVTPL financial liabilities where fair value changes resulting from changes in own credit risk are recognised in other comprehensive income (OCI).</p>

<p>Designation: An entity must designate a hedging instrument in full, except for:</p> <ul style="list-style-type: none"> <li>A proportion (e.g. 50%) of the nominal amount an entire hedging instrument (but not part of the fair value change resulting from a portion of the time period that the hedging instrument is outstanding)</li> <li>Option contracts: separating the intrinsic value and time value, and designating only the change in intrinsic value</li> <li>Forward contract: separating the forward element and spot element, and designating only the change in the spot element.</li> </ul>
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**ELIGIBLE HEDGED ITEMS**

<p>Eligible hedged items are reliably measurable: assets; liabilities; unrecognised firm commitment; highly probable forecast transactions; net investment in a foreign operation. May be a single item, or a group of items (subject to additional criteria - below).</p>
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**HEDGES OF A GROUP OF ITEMS (ALL CRITERIA MUST BE MET)**

<p>(i) All items and (and components) are eligible hedged items</p> <p>(ii) The items are managed as a group for risk management purposes.</p>	<p>(iii) For group cash flow hedges: where cash flow variability is not expected to be approximately proportional to the overall group cash flows variability, both:</p> <ul style="list-style-type: none"> <li>Foreign currency is being hedged</li> <li>The reporting period, nature, and volume, in which the forecast transactions are expected to affect profit or loss is specified.</li> </ul>
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<p>Designation: An entity can designate a hedged item (i) in full (ii) in part (component). If in part, only the following types of parts (components) of hedged items can be hedged:</p> <ul style="list-style-type: none"> <li>One or more selected contractual cash flows</li> <li>Parts (components) of a nominal amount</li> <li>Separately identifiable and reliably measureable changes (cash flow or fair value) that, based on the context of the market structure they relate to, are attributable to a specific risk(s).</li> </ul>
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**HEDGING OF GROUP ENTITY TRANSACTIONS**

<p>Hedging of group entity transactions is not applied in the consolidated financial statements of group entities, except for:</p> <ul style="list-style-type: none"> <li>Foreign currency risk on intra-group monetary items that are not fully eliminated on consolidation.</li> <li><b>Investment entities</b> where transactions between the parent and subsidiaries measured at fair value are not subject to elimination adjustments.</li> </ul> <p>Hedging of group entity transactions is able to be applied in separate/individual financial statements of group entities.</p>
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**REBALANCING**

<p>If the hedge ratio hedge effectiveness test ceases to be met, but the risk management objective is unchanged, an entity adjusts ('rebalances'), the hedge ratio so the criteria is once again met.</p>
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**DISCONTINUATION**

<p>Hedge accounting is discontinued only if the qualifying criteria are no longer met (after applying 'rebalancing'). This including hedging instrument sale / termination / expiration, but excluding:</p> <ul style="list-style-type: none"> <li>Replacement/rollovers documented in the risk management objective</li> <li>Novations of hedging instruments (subject to specific criteria).</li> </ul>
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**ELIGIBLE HEDGED ITEMS**

<p><b>(i) Cash flow hedge</b></p> <p>Hedge of exposure to cash flow variability in cash attributable to a particular risk associated with an asset, liability, or highly probable forecast transaction (or part thereof i.e. component).</p> <p><b>Recognition</b></p> <ul style="list-style-type: none"> <li>Hedge effectiveness is recognised in OCI</li> <li>Hedge ineffectiveness is recognised in profit or loss</li> <li>The lower of the cumulative gain or loss on the hedging instrument or fair value in the hedged item is recognised separately within equity (cash flow hedge reserve (CFHR)).</li> <li>For forecast transactions resulting in a non-financial asset/liability, the amount recognised in CFHR is removed and included in the initial cost of the non-financial asset/liability. This is not accounted for as a reclassification.</li> <li>For all other forecast transactions, the amount recognised in CFHR is reclassified to profit or loss in the periods when the cash flows are expected to affect profit or loss.</li> </ul>	<p><b>(ii) Fair value hedge</b></p> <p>Hedge of exposure to fair value variability in an asset, liability, or unrecognised firm commitment (or part thereof i.e. component), attributable to a risk that could affect profit or loss.</p> <p><b>Recognition</b></p> <ul style="list-style-type: none"> <li>Gain or loss on hedging instrument: recognised in profit or loss (unless the hedging instrument is an equity instrument measured at fair value through OCI, then recognised in OCI).</li> <li>Gain or loss on hedged item: recognised in profit or loss (unless the hedged item is an equity instrument measured at fair value through OCI, then recognised in OCI).</li> </ul>	<p><b>(iii) Hedges of a net investment in a foreign operation</b></p> <p>Hedge of an entity's interest in the net assets of a foreign operation.</p> <p><b>Recognition</b></p> <ul style="list-style-type: none"> <li>Hedge effectiveness is recognised in OCI</li> <li>Hedge ineffectiveness is recognised in profit or loss</li> <li>Upon disposal of the foreign operation, accumulated amounts in equity are reclassified to profit or loss.</li> </ul>
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# CONTACT

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below.

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