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In July 2014, the International Accounting Standard Board (IASB) issued the final version of IFRS 9 *Financial Instruments* that combines together the classification and measurement, impairment and hedge accounting phases of the IASB's project to **replace the IAS 39** ***Financial Instruments: Recognition and Measurement***.

IFRS 9 FINANCIAL INSTRUMENTS

This publication will discuss the general concepts of the standard, including the following:

* Reasons for Issuing the Standard
* Scope
* Recognition and Derecognition
* Classification of Financial Assets and Financial Liabilities
* Embedded Derivatives
* Reclassification
* Measurement
* Impairment
* Hedge Accounting
* Presentation
* Effective Date and Transition

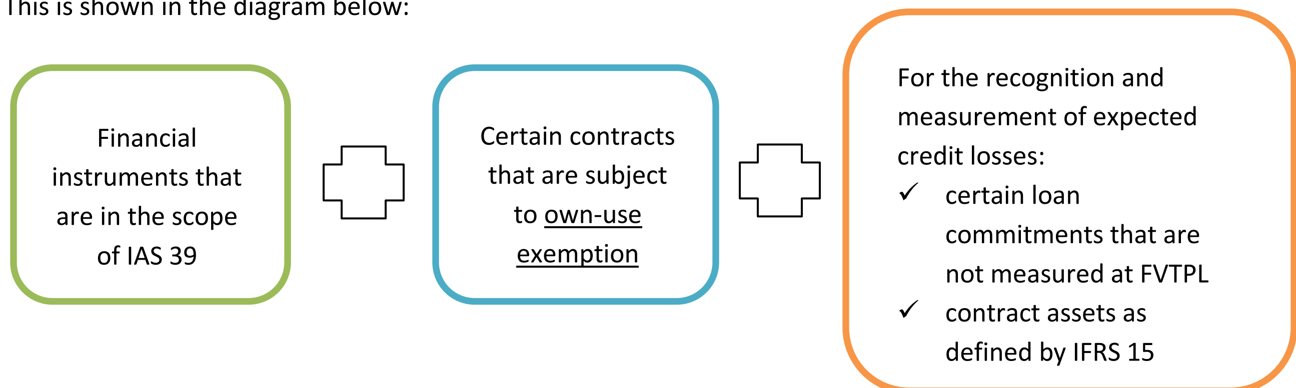
Reasons for Issuing the Standard

Many users of financial statements and other interested parties have found that the requirements in IAS 39 were difficult to understand, apply and interpret mainly due to the following:

- Classification of financial assets and liabilities:
  - ✓ rule-based
  - ✓ complex and difficult to apply
  - ✓ multiple impairment models
  - ✓ own credit gains and losses recognized in profit or loss for fair value option liabilities
  - ✓ complicated reclassification rules
- Impairment: delayed recognition of credit losses on loans
- Hedged accounting requirements:
  - ✓ do not reflect risk management appropriately
  - ✓ insufficient disclosure on entity's risk management activities

Scope

Generally, the scope of IAS 39 is only carried forward to IFRS 9 with certain other instruments added only. This is shown in the diagram below:



Note

Certain contracts that are subject to own-use exemption:

- *A contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contract was a financial instrument.*
- *May be irrevocably designated as measured at fair value through profit or loss even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.*

Recognition and Derecognition

Generally, the requirements for recognition and derecognition of IAS 39 are carried forward to IFRS 9 with certain minor amendments only. These include the following:

- clarification that a write-off constitutes a derecognition event for a financial asset or a portion thereof, and
- modification of the terms of a financial asset may lead to its derecognition.

The definition of financial instrument, including financial asset, financial liability and equity instrument did not change. *(See IAS 32 Financial Instruments: Presentation)*

Classification of Financial Assets

IFRS 9 provides three (3) principal measurement categories, namely:

- amortised cost,
- fair value through other comprehensive income (FVOCI), and
- fair value through profit or loss (FVTPL) *(residual category)*.

Notice that the existing categories under IAS 39 such as held-to-maturity, loans and receivables, and available-for-sale are already removed. In addition, the exception that allows certain equity investments and derivatives linked to such investments, to be measured at cost are removed.

Now in order to determine the classification of a financial asset, IFRS 9 provides two (2) criteria:

- business model for managing the financial asset *(Business model criterion)*, and
- contractual cash flow characteristics of the financial asset *(SPPI criterion)*.

  Note: SPPI means solely payment of principal and interest.

The assessment of the foregoing criteria and its resulting measurement categories are as follows:

- *Amortised cost measurement category*

  A financial asset is classified as subsequently measured at amortised cost if it:

  ✓ meets the SPPI criterion; and

  ✓ is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows.

- *FVOCI measurement category*

  A financial asset is classified as subsequently measured at FVOCI if it:

  - meets the SPPI criterion; and
  - is held in a business model in which assets are managed both in order to collect contractual cash flows and for sale.

- *FVTPL measurement category (residual category)*

  All other financial assets that do not meet the criteria for classification as subsequently measured at either amortised cost or FVOCI are classified as subsequently measured at fair value, with changes in fair value recognised in profit or loss.

- *FVTPL election for financial assets*

  Similar to IAS 39, an entity has the option at initial recognition to irrevocably designate a financial asset as at FVTPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency.

- *FVOCI election for equity instruments*

  At initial recognition, an entity may make an irrevocable election to present in OCI subsequent changes in the fair value of an investment in an equity instrument that is neither held for trading nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 *Business Combinations* applies.

To reiterate one of the criteria for determining the classification of financial asset is whether the cash flows meet the SPPI criterion. A financial asset that does not meet the SPPI criterion is automatically measured at FVTPL, unless it is an equity instrument for which an entity applies the OCI election.

And as previously discussed, SPPI criterion constitute two types of cash flows, namely:

- Principal
  - ✓ Fair value of the financial asset at initial recognition. However, principal may change over time – e.g. if there are repayments of principal.
- Interest is consideration for:
  - ✓ the time value of money; and
  - ✓ the credit risk associated with the principal amount outstanding during a particular period of time.

  It can also include:

  - ✓ consideration for other basic lending risks (e.g. liquidity risk) and costs (e.g. administrative costs); and
  - ✓ a profit margin.

It is important to understand that in order for contractual cash flows to be SPPI they must include returns consistent with a basic lending arrangement. The following are considered in assessing the SPPI criterion:

- contractual features that introduce exposure to risks or volatility in the contractual cash flows;
- financial asset with modified time value element;
- regulated interest rates;

- 'de minimis' features;
- contingent events affecting cash flows;
- prepayments and extension options;
- contractually linked instruments; and
- non-recourse provision.

On the other hand, in assessing the business model we should understand the how the entity manages its financial assets in order to generate cash flows. That is, the entity's business model determines whether cash flows will result from collecting contractual cash flows, selling the financial assets or both.

The following table summarises the key features of each type of business model and the resultant measurement category.

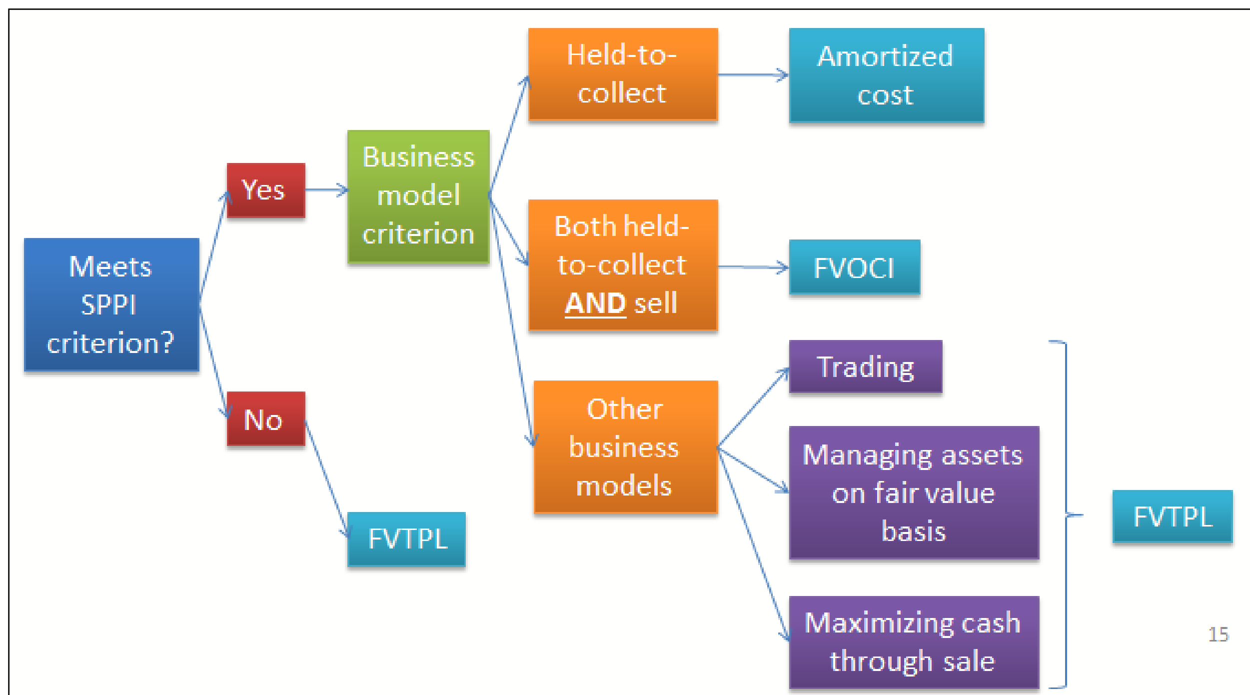
Business Model	Key Features	Measurement Category
Held to collect	✓ The objective of the business model is to hold assets to collect contractual cash flows ✓ Sales are incidental to the objective of the model ✓ Typically lowest sales (infrequency and volume)	Amortised cost (a)
Both held to collect and for sale	✓ Both collecting contractual cash flows and sales are integral to achieving the objective of the business model ✓ Typically more sales (in frequency and volume) than held-to-collect business model	FVOCI (a)
Other business models, including: **✓ trading** **✓ managing assets on a fair value basis** **✓ maximising cash flows through sale**	✓ Business model is neither held-to-collect nor held to collect and for sale ✓ Collection of contractual cash flows is incidental to the objective of the model	FVTPL (b)

Note

(a) Subject to meeting the SPPI criterion and fair value option

(b) SPPI criterion is irrelevant – assets in all such business model are measured at FVTPL

The diagram below provides a summary of the classification of financial assets.



Note

The diagram above does not include the following:

- ✓ *FVTPL election for financial assets*
- ✓ *FVOCI election for equity instruments*

Classification of Financial Liabilities

Financial liabilities may be classified as follows:

- Amortized cost
  - ✓ All financial liabilities, except those that meet the criteria for FVTPL
  - ✓ Subsequently measured at amortized cost using effective interest method
- Fair value through profit or loss
  - ✓ Financial liabilities that are held for trading – including derivatives
  - ✓ Financial liabilities that are designated as at FVTPL on initial recognition
  - ✓ Subsequently measured at fair value with all gains and losses recognized in profit or loss

The option in IAS 39 pertaining to designation of financial liabilities at fair value on initial recognition is retained.

Also, under IAS 39, all fair value changes on liabilities designated under the fair value option are recognised in profit or loss. However, under IFRS 9, fair value changes are presented as follows: *(Split presentation)*

- the amount of change in the fair value that is attributable to changes in the credit risk of the liability is presented in OCI; and
- the remaining amount of change in the fair value is presented in profit or loss.

  Note: Amounts presented in OCI are never reclassified to profit or loss. However, an entity may transfer the cumulative gain or loss within the equity.

The reason behind this split presentation is that many observers have expressed their concerns about an entity applying the fair value option and, as a result, recognising gains in profit or loss when its credit standing deteriorates (and vice-versa). This result is considered as counter-intuitive. Hence, to address this issue the standard requires those changes to be recognized in OCI.

Impact to Business

The assessment of SPPI and business model criteria will require judgment to ensure that financial assets are classified appropriately. This will include assessment of contractual provisions and how an entity manages its financial assets. New processes (both accounting and I.T.) will be needed to take into account the requirements of the new standard. In addition, this could affect the calculation of capital resources and capital requirements of entities, particularly those in financial services, due to capital requirements or other national capital adequacy requirements.

The new classification and measurement of financial assets will result in volatility within profit or loss and equity, which are likely to impact key performance indicators. On the other hand, the own credit requirements for financial liabilities (i.e. split presentation) will reduce profit or loss volatility.

Embedded Derivatives

IFRS 9 retains the IAS 39 definition of an embedded derivative and most of the associated guidance on separation.

Under the new standard, when host contracts are financial assets, the entire hybrid contract, including all embedded features, is assessed for classification under IFRS 9. No separation is permitted.

However, when host contracts are not financial assets in the scope of IFRS 9, an entity assesses whether the embedded feature requires separation. The assessment is the same as that currently required under IAS 39.

In addition, IFRS 9 retains the IAS 39 requirements for accounting for embedded derivatives in hybrid contracts where the host is a financial liability or a contract that is not a financial instrument.

The following are examples of host instruments that have to be assessed for separation:

Type of Host	Examples
Financial assets not in the scope of IFRS 9	Insurance contracts, lease receivables
Financial liabilities	Debt securities, loans
Non-financial items	Forward purchase contracts for goods and services

Reclassification

The reclassification of financial assets is required if, and only if, the objective of the entity's business model for managing those financial assets changes. Such changes should be significant to the entity's operation and demonstrable to external parties. In addition, IFRS 9 does not contain any guidance requiring or allowing an entity to reclassify assets based on a reassessment of the SPPI criterion after initial recognition.

It is to be noted that IFRS 9 does not permit reclassification of financial liabilities.

To illustrate, let us assume the following scenarios:

Change in business model

1. ABC has a portfolio of commercial loans that it holds to sell in the short term. ABC acquires DEF that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows.

   Comment

   The original portfolio of commercial loans is no longer for sale, and this portfolio is now managed together with the acquired commercial loans. All of the loans are held to collect the contractual cash flows.

   - *Change in classification: FVTPL to Amortised cost*

2. A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

   Comment

   - *Change in classification: Amortized cost to FVTPL*

Not a change in business model

1. An entity changes its intention for particular financial assets (even in circumstances of significant changes in market conditions).
2. A particular market for financial assets temporarily disappears.
3. Financial assets are transferred between parts of an entity with different business models.

It is to be noted that all affected assets shall be reclassified prospectively from the first day of the next reporting period (the reclassification date). Prior periods are not restated.

In addition, IFRS 9 provides the following guidelines on measurement on reclassification of financial assets.

		Reclassification to	
Reclassification from		**FVOCI**	**Amortized Cost**
	FVTPL	Fair value on reclassification date = new gross carrying amount Calculate EIR based on new gross carrying amount Recognize subsequent changes in fair value in OCI	Fair value on reclassification date = new gross carrying amount Calculate EIR based on new gross carrying amount
		FVTPL	**Amortized Cost**
	FVOCI	Reclassify accumulated OCI balance to profit or loss on reclassification date.	Reclassify financial asset at fair value. Remove cumulative balance from OCI and use it to adjust the reclassified fair value. Adjusted amount = amortized cost EIR determined at initial recognition and gross carrying amount are adjusted as a result of reclassification
		FVTPL	**FVOCI**
	Amortized Cost	Fair value on reclassification date = new carrying amount Recognize difference between amortized cost and fair value in profit or loss.	Remeasure to fair value, with any difference recognize in OCI. EIR determined at initial recognition is not adjusted as a result of reclassification.

Measurement on Initial Recognition

The requirements under IAS 39 on initial recognition are retained. Accordingly, on initial recognition, financial assets and financial liabilities are measured at fair value plus, for financial instruments not at FVTPL, directly attributable transaction costs. The guidance on fair value determination is on IFRS 13 *Fair Value Measurement*.

Also, the following guidance under IAS 39 is retained:

- the best evidence of fair value at initial recognition is normally the transaction price; and
- if there is a difference between the entity's estimate of fair value at initial recognition and the transaction price, then:
    - ✓ if the estimate of fair value uses only data from observable markets, then the difference is recognised in profit or loss; or

- ✓ in all other cases, the difference is deferred as an adjustment to the carrying amount of the financial instrument.

In addition, IFRS 9 requires trade receivables that do not have a significant financing component to be initially recognised at their transaction price (as defined in IFRS 15 *Revenue from Contract with Customers* – i.e. the amount of consideration to which the entity expects to be entitled), rather than at fair value.

Subsequent Measurement

A financial asset is subsequently measured at amortised cost, FVOCI or FVPTL. IFRS 9 provides the following guidelines:

Amortised cost

The following items are recognised in profit or loss:

- interest revenue using the effective interest method;
- expected credit losses and reversals; and
- foreign exchange gains and losses.

When the financial asset is derecognised, the gain or loss is recognised in profit or loss.

Fair value through other comprehensive income

Gains and losses are recognised in OCI, except for the following items, which are recognised in profit or loss in the same manner as for financial assets measured at amortised cost:

- interest revenue using the effective interest method;
- expected credit losses and reversals; and
- foreign exchange gains and losses.

When the financial asset is derecognised, the cumulative gain or loss previously recognised in OCI is reclassified from equity to profit or loss.

Equity investments – presentation of gains or losses in OCI

- Gains and losses are recognised in OCI.
- Dividends (as defined in IFRS 9) are recognised in profit or loss unless they clearly represent a repayment of part of the cost of the investment.
- The amounts recognised in OCI are not reclassified to profit or loss under any circumstances.

Fair value through profit or loss

Gains and losses, both on subsequent measurement and derecognition, are recognised in profit or loss.

In addition, IFRS 9 removes the exception for certain equity investments and derivatives linked to such investments, to be measured at cost; instead requires it to be subsequently measured at fair value, like other investments in equity instruments and derivatives.

However, in limited circumstances, cost may still be an appropriate estimate of fair value for such items if:

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

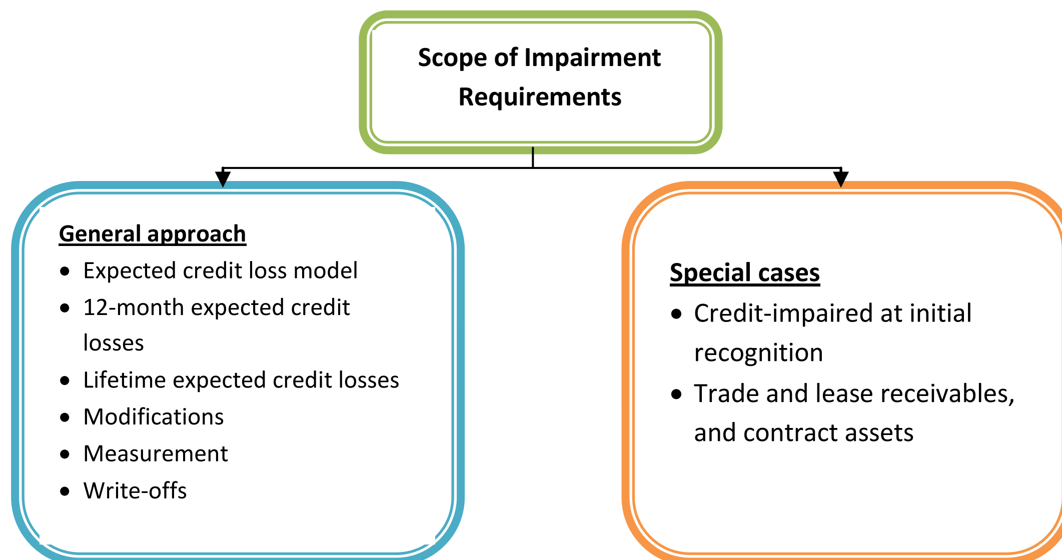
With regard to subsequent measurement of financial liabilities, IFRS 9 retains almost all the existing requirements from IAS 39. Generally, financial liabilities are subsequently measured:

- at amortised cost,
- at FVTPL, or
- under specific measurement guidance carried forward from IAS 39.

And, as previously discussed IFRS 9 changes the principles for the presentation of gains and losses on financial liabilities that are designated as at FVTPL, resulting in a split presentation of such gains and losses.

Impairment

The following diagram summarizes the key concepts of impairment.



The following table sets out instruments that are within and outside the scope of impairment requirements.

Within	Outside
Financial assets that are debt instruments measured at amortised cost or at FVOCI – these include loans, trade receivables and debt securities	Equity investments
Loan commitments issued that are not measured at FVTPL	Loan commitments issued that are measured at FVTPL

Within	Outside
Financial guarantee contracts issued that are in the scope of IFRS 9 and are not measured at FVTPL	Other financial instruments measured at FVTPL
Lease receivables in the scope of IAS 17	
Contract assets in the scope of IFRS 15	

Note: IFRS 9 provides a single impairment model that applies to all financial instruments in its scope.

Under IFRS 9, impairment is measured as either:

- *12-month expected credit losses*

  The portion of lifetime expected credit losses that represent the expected credit losses that result from default events on the financial instrument that is possible within the twelve (12) months after the reporting date.

- *Lifetime expected credit losses*

  The expected credit losses that result from all possible default events over the expected life of the financial instrument.

Below is the overview of the impairment model.

- *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.
  - ✓ 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.
  - ✓ 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. gross carrying amount adjusted for the loss allowance).
  - ✓ Financial assets in this stage will generally be individually assessed.

To illustrate, let us assume the following circumstances:

- ABC Company has portfolio of home loans originated in a country.

  In stage 1, the Company has to recognize 12-month expected credit losses for all the loans on initial recognition.

- Then information emerges that a region in the country is experiencing tough economic conditions.

  Here, the Company will enter in stage 2, where it has to recognize lifetime expected credit losses for those loans within that region; while all other loans should still be under stage 1.

- More information emerges and the entity is able to identify the particular loans that have defaulted or will imminently default.

  At this point, the Company will enter stage 3, where lifetime expected credit losses continue to be recognized and interest revenue switches to a net interest basis.

An entity should consider following when measuring expected credit losses:

- probability-weighted outcome;
- time value of money; and
- reasonable and supportable information that is available without undue cost or effort.

As previously discussed, the following are the special cases of impairment:

- credit-impaired at initial recognition, and
- trade and lease receivables, and contract assets.

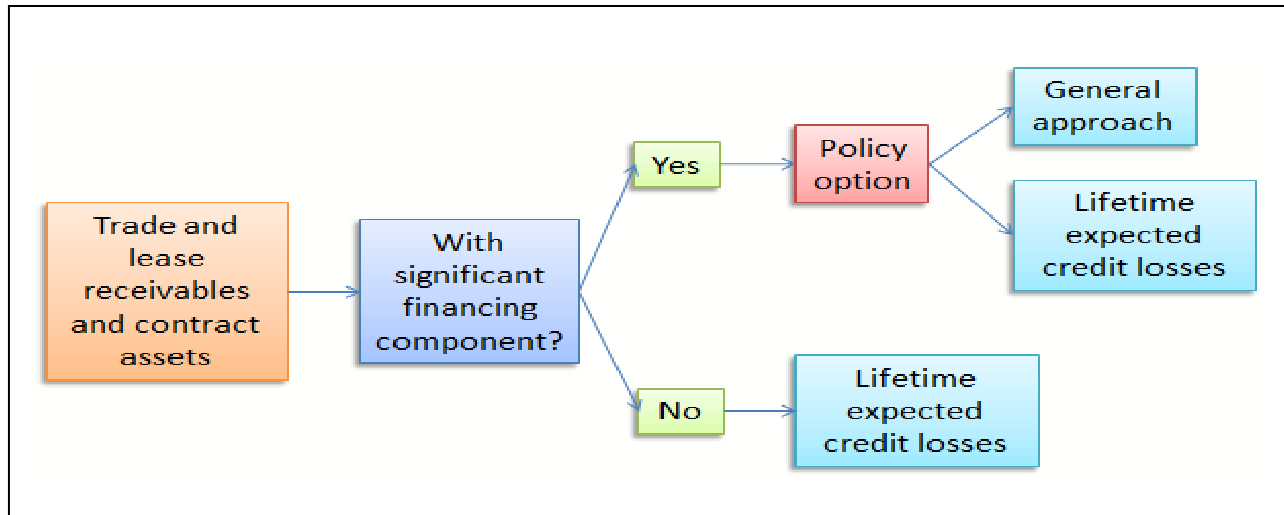
Credit-impaired at initial recognition

An asset is credit-impaired if one or more events have occurred that have a detrimental impact on the estimated future cash flows of the asset. The definition lists the following examples of such events:

- significant financial difficulty of the issuer or the borrower;
- a breach of contract – e.g. a default or past-due event;
- a lender having granted a concession to the borrower – for economic or contractual reasons relating to the borrower's financial difficulty – that the lender would not otherwise consider;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- the purchase of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event. Instead, the combined effect of several events may cause financial assets to become credit-impaired.

Trade and lease receivables, and contract assets



Impact to Business

Entities will need to ensure that the measurement of expected credit losses reflects reasonable and supportable information that is available without undue cost or effort and that includes historical, current and forecast information. Certainly, this will have a significant impact on the systems and processes of all entities, particularly to those in financial services, due to extensive requirements for data and calculations. These data and calculation requirements may include:

- ✓ *estimates of 12-month and lifetime expected credit losses;*
- ✓ *information on occurrence and reversal of significant increase in credit risk; and*
- ✓ *data for the extensive new disclosure requirements.*

The initial application of the new model (i.e. expected credit loss model) will significantly impact the equity of all entities, particularly financial services entities, due to recognition of expected credit losses on top of incurred credit losses.

Hedge Accounting

IFRS 9 includes a new general hedge accounting model, which aligns hedge accounting more closely with risk management. The new model does not fundamentally change the types of hedging relationships or the requirement to measure and recognise ineffectiveness under IAS 39; however, under the new model more hedging strategies that are used for risk management may qualify for hedge accounting. In addition, IFRS 9 introduces consequential amendments to the hedge accounting requirements originally released in IFRS 9 (2013), to reflect the introduction of the new FVOCI classification category for financial assets.

Presentation

IFRS 9 amends IAS 1 *Presentation of Financial Statements* to require the following line items to be presented:

- revenue, presenting separately interest revenue calculated using the effective interest method;
- gains or losses arising from the derecognition of financial assets measured at amortised cost;
- impairment losses (including reversals) determined in accordance with IFRS 9;
- gains or losses arising on reclassification of a financial asset out of the amortised cost category into the FVTPL category; and
- if a financial asset is reclassified out of the FVOCI category into the FVTPL category, any cumulative gain or loss previously recognised in OCI that is reclassified to profit or loss.

Effective Date

IFRS 9 shall be applied for annual periods beginning or after January 1, 2018. Earlier application is permitted.

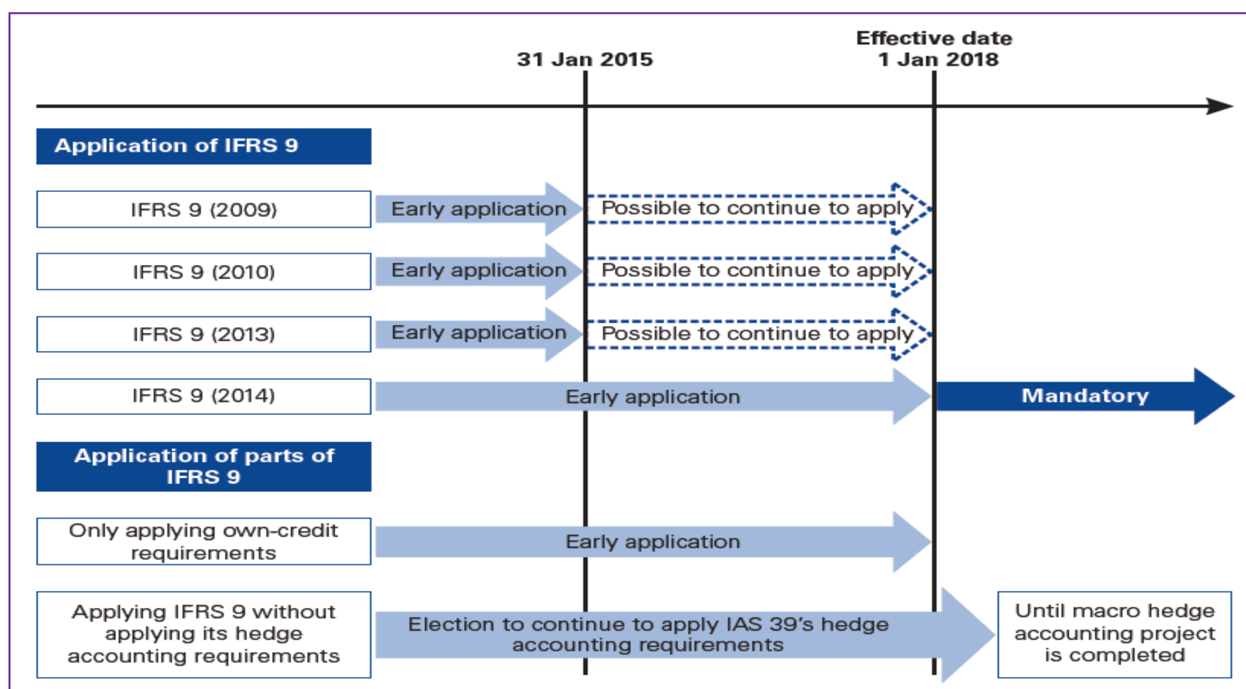
If an entity applies this standard early it is required to apply all of its requirements, except for the following:

- an entity is allowed to early adopt the own-credit requirements introduced by IFRS 9 (2010) in isolation;
- an entity may choose to continue to apply the hedge accounting requirements of IAS 39 until the macro hedge accounting project is completed; and
- special requirements exist for sequential adoption from previous versions of IFRS 9.

IFRS 9 (issued in July 2014) will supersede the following standards:

- IAS 39 Financial Instruments: Recognition and Measurement
- IFRS 9 Financial Instruments (issued November 2009)
- IFRS 9 Financial Instruments (issued October 2010)
- IFRS 9 Financial Instruments (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39)

Adoption of Different Versions of IFRS 9



Transition

Generally, IFRS 9 shall be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except for the following:

- exception from the requirement to restate comparative information, which also applies if an entity elects to early adopt the own credit requirements in isolation;
- hedge accounting requirements are generally applied prospectively, with limited exceptions; and
- not applied to financial assets or financial liabilities that have been derecognised at the date of initial application.

What the Entities can do?

Entities may consider the following:

- developing appropriate methodologies and related controls to ensure that judgment is exercised appropriately and consistently;
- assessing the impact and developing a plan to mitigate any negative consequences; and
- understanding the impact and communicating it to key stakeholders to ensure that the potential impact will be properly understood and addressed.

…XXX…

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