IFS 9: Financial Instruments

Last updated: October 2015

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SCOPE

Applies to all types of financial instruments *("FI")* (i.e., contract that gives rise to a financial asset *("FA")* of one entity and financial liability *("FL")*/equity instrument *("EI")* of another entity). Specifically:

- Loan commitments designated as @ fair value through profit and loss ("*FVTPL*") or at below-market interest rates.
- Derivatives (including embedded derivatives) relating to leases, loan commitments, insurance contracts, interest in subsidiaries, associates or joint ventures (if derivative liability).
- Receivables arising from customer contracts (IFRS 15).

Exceptions relating to:

- Interests in subsidiaries, associates and joint ventures (IFRS 10, IAS 27 or 28).
- Leases (IAS 17).
- Employee benefit plans (IAS 19).
- FI classified as EI under IAS 32 (holder still applies IFRS 9).
- Share-based payment transactions (IFRS 2).
- Insurance contracts (IFRS 4).
- FIs with discretionary participation features (IFRS 4).
- Financial guarantee contracts.
- Forward contracts that result in business combination (IFRS 3).
- Loan commitments.
- Reimbursement rights recognized as a provision (IAS 37).
- Certain rights and obligations relating to revenue from customer contracts (IFRS 15).
- Contracts to buy/sell non-financial items that can be settled net in cash/another FI/by exchanging FIs, as if contracts were FIs which were entered into and still held for receipt/delivery of non-financial item based on entity's expected purchase/sale/usage requirements and were NOT irrevocably designated as measured @ FVTPL.

INITIAL RECOGNITION

Recognize FI when entity becomes party to instrument's contractual provisions (i.e., trade date) except for:

- **Regular way purchases or sales** = delivery required within time frame generally set by regulation/convention in marketplace. Apply trade or settlement date accounting.
  - Trade date accounting→ regular recognition and derecognition.
  - Settlement date accounting→ asset recognized when received. Change *("Δ")* in fair value *("FV")* between trade and settlement date recognized as follows:
    - FI @ amortized cost – not recognized.
    - FI @ FVTPL – in profit/loss *("P/L")*.
    - FI @ FVOCI – in other comprehensive income ("*OCI*").

EMBEDDED DERIVATIVE

Derivative = FI/other contract within scope of IFRS 9 with ALL the following characteristics: (1) Value Δs in response to Δ in 'underlying'. (e.g. interest rate/ commodity price, etc. and if non-fin. variable → variable is NOT specific to contract party); (2) no initial investment/ smaller than for similar contracts; AND (3) settled at a future date (e.g. forwards/futures, options, caps/floors etc.).

Embedded derivative = component of hybrid (combined) instrument that also includes non-derivative host contract. Excludes a derivative that is contractually independently transferable/has a different counterparty.

- Effect = Cash flows *("CF")* of combined instrument vary in a similar way to stand-alone derivative.
- Host = FA → apply classification requirement to entire hybrid contract (i.e., no separation of derivative).
- Host ≠ FA → refer to IFRS 9 for guidance on separately accounting for derivative/ designating the combined instrument as at FVTPL.

CLASSIFICATION AND INITIAL MEASUREMENT

FINANCIAL ASSETS	FINANCIAL LIABILITIES	
Based on business model for managing FA and contractual CF characteristics of the FA., classify as @: ▪ Amortized cost ▪ FVOCI or ▪ FVTPL (See Appendix A below.)	**Amortized cost** except for: ▪ FL arising from transfer of FA not qualifying for derecognition or requiring continuing involvement. ▪ Financial guarantee contracts. ▪ Loan commitments provided @ a below-market interest rate. ▪ Those @ FVTPL.	**@ FVTPL:** ▪ FL held for trading (including derivatives that are liabilities). ▪ Acquirer's contingent consideration from a business combination. ▪ FL irrevocably designated as @ FVTPL because eliminates/reduces an accounting mismatch, managed/evaluated on a FV basis or contains an embedded derivative.

RECLASSIFICATION

FA: only allowed when Δ in business model.

- Changes as a result of hedge accounting → not considered a reclassification.

FL: Reclassification not allowed.

INITIAL MEASUREMENT

- All *FIs* → FV *(See IFRS 9.B5.1.2A if FV ≠ transaction price.)*
  - If amortized cost or FVOCI → plus/minus directly attributable transaction costs.
- Trade receivables without a significant financing component or if the entity applies the practical expedient in IFRS 15.63 → transaction price (see IFRS 15 definition).

SUBSEQUENT MEASUREMENT AND GAINS/LOSSES

FINANCIAL ASSET	FINANCIAL LIABILITY
@ Amortized cost: Foreign exchange (FX), impairment gains/ losses and interest using effective interest rate method in P/L. **Equity investments @ FVOCI:** Dividends in P/L and Δ in FV in OCI with no reclassification/recycling to P/L. **Other investments @ FVOCI:** Same treatment as under amortized cost except Δ in FV recognized in OCI with reclassification to P/L on derecognition. **@FVTPL**: Δ in FV in P/L	**@ Amortized cost**: FX gains/losses and interest expense using *EIR* method all recognized in P/L. **@ FVTPL**: Effect of changes in entity's own credit risk recognized in OCI with remaining Δ in FV in P/L. (If creates/enlarges accounting mismatch in P/L, entire Δ in FV recognized in P/L.)

AMORTIZED COST AND EFFECTIVE INTEREST RATE

- **Effective interest rate *("EIR")* =** Rate that discounts estimated future CFs through expected life of FA to gross carrying amount of FA or amortised cost of FL.
- **Amortized cost =** Initially recognized amount MINUS the principal repayments PLUS/MINUS cumulative amortization using EIR method MINUS loss allowance (if FA).

Apply EIR to gross carrying amount of FA EXCEPT for:

- Purchased or originated credit-impaired FA → apply credit-adjusted EIR to amortized cost of FA from initial recognition. (Only Δs in loss allowance is recognized even if positive).
- FA that subsequently becomes credit-impaired → apply EIR to amortized cost of FA in subsequent periods.

Credit-impaired FA = one/more events occurred with a detrimental impact on estimated future CFs of FA. Evidence that a FA is credit-impaired includes observable data about, for example, a breach of contract, probable bankruptcy, significant financial difficulty, FA purchased at deep discount, etc.

Credit-adjusted EIR = Rate that discounts estimated future CFs through expected life of FA to the amortized cost of a FA that is a purchased/originated credit-impaired FA.

Gross carrying amount of FA: Amortized cost before adjusting for loss allowance.

This communication contains a general overview of the topic and is current as of October 15, 2015. The application of the principles addressed will depend upon the particular facts and circumstances of each individual case. Accordingly, this publication is not a substitute for professional advice and we recommend that any decisions you take about the application or not of any of the information presented be made in consultation with a qualified professional, who can address any variance that may be required to reflect your circumstances. Please contact your local MNP representative for customized assistance with the application of this material. MNP LLP accepts no responsibility or liability for any loss related to any person's use of or reliance upon this material. © MNP LLP 2015. All rights reserved.

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IMPAIRMENT

Recognize loss allowance for debt instrument FAs measured @ amortized cost or FVOCI (e.g. loans, debt investments and receivables), contract assets (IFRS 15), lease receivables (IAS 17), and loan commitments or financial guarantee contracts not measured @ FVTPL. (N/A to equity investments and FIs @ FVTPL).

1) Recognize **lifetime expected credit losses =** expected credit losses *("ECL")* from all possible default events over expected life of FI, IF either:
   - Credit risk significantly ↑ since initial recognition and not considered low, or
   - Purchased or originated credit-impaired FA.
2) **OTHERWISE**, recognize **12-month ECL** = portion of lifetime ECL from default events possible within 12 months after the reporting date.

Simplified approach:

- Always use lifetime ECL for trade receivables or contract assets within scope of IFRS 15 if no significant financing component or entity applies the practical expedient for contracts that </= one year.
- Make accounting policy choice to use lifetime ECL for lease receivables within scope of IAS 17 and trade receivables/contract assets within scope of IFRS 15 that contain a significant financing component.

Significant ↑ in credit risk

- Assess ↑ in probability of occurrence of default since initial recognition.
- Rebuttable presumption that credit risk has ↑ significantly when contractual payments are > 30 days past due.

Measurement of ECL of a FI reflects: 1) an unbiased and probability-weighted amount determined by evaluating a range of possible outcomes; 2) the time value of money; and 3) reasonable and supportable information available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

- **Credit loss =** present value *("PV")* of difference between contractual CFs due and CFs the entity expects to receive (i.e., cash shortfalls) discounted using original EIR or credit-adjusted EIR for purchased/originated credit-impaired FA.
  - For undrawn loan commitments, CFs must consider expected drawdowns on loan

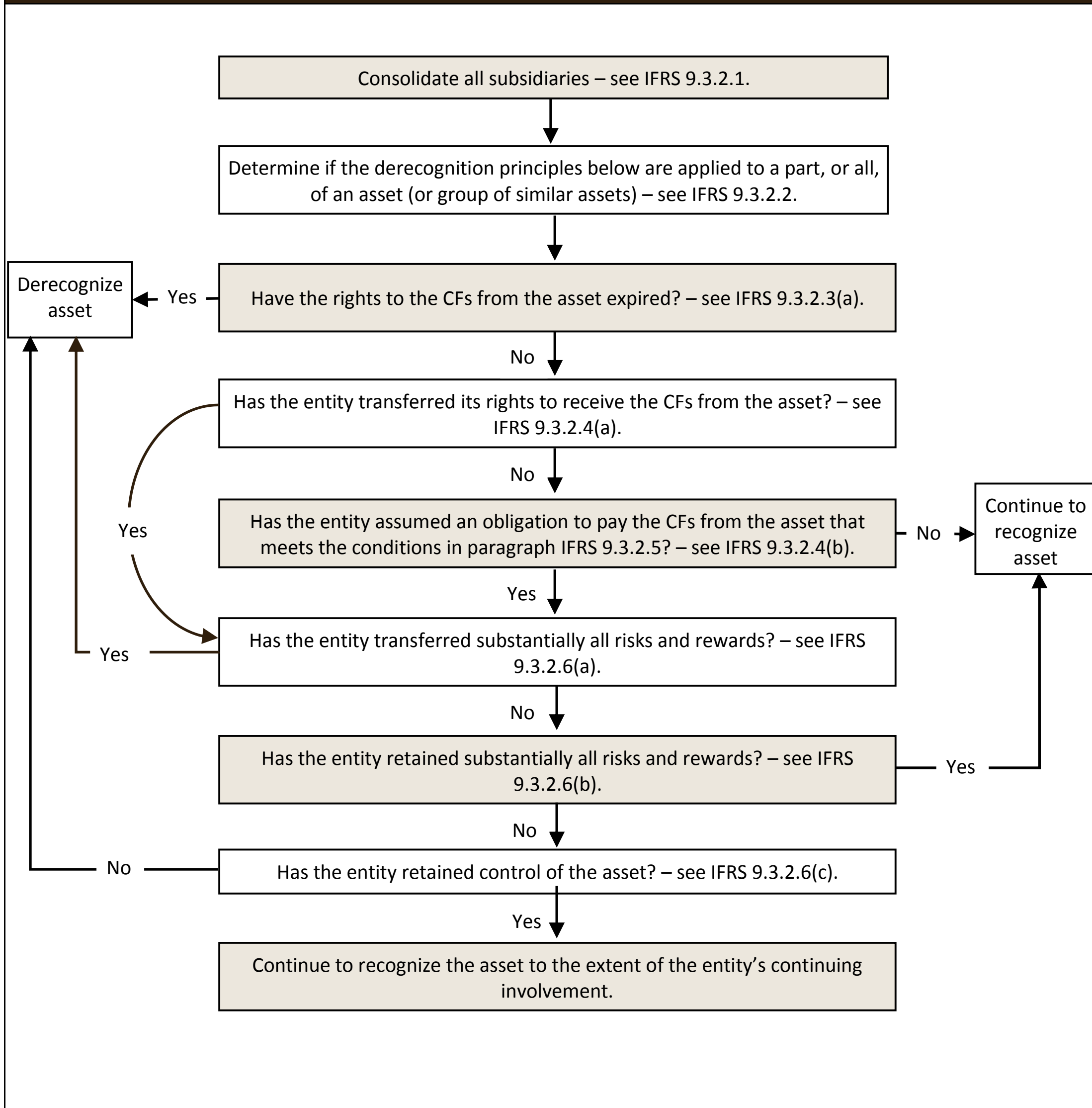
Financial guarantee contract = requires issuer to make specified payments to reimburse holder for loss incurred because specified debtor fails to make contractual payments.

  - For financial guarantee contracts, cash shortfalls are the expected payments to reimburse holder for credit loss incurred MINUS amounts recovered from holder/debtor/other party.

Loss allowance recognized in P/L and for:

- FAs measured @ amortized cost, lease receivable or contract asset → netted against carrying amount of FA.
- Loan commitment or financial guarantee contract → recognized as provision.
- Debt instruments measured @ FVOCI → recognized in OCI (i.e., not netted against carrying amount of FA.

DERECOGNITION OF A FA



DERECOGNITION OF A FL*

- Derecognize FL (or part of) when obligation in contract is extinguished (i.e., discharged/cancelled/expired).
- For substantial modification/exchange of substantially different FIs → extinguish and recognize new liability with difference in P/L.

**Applies to all loan commitments and lease payables.*

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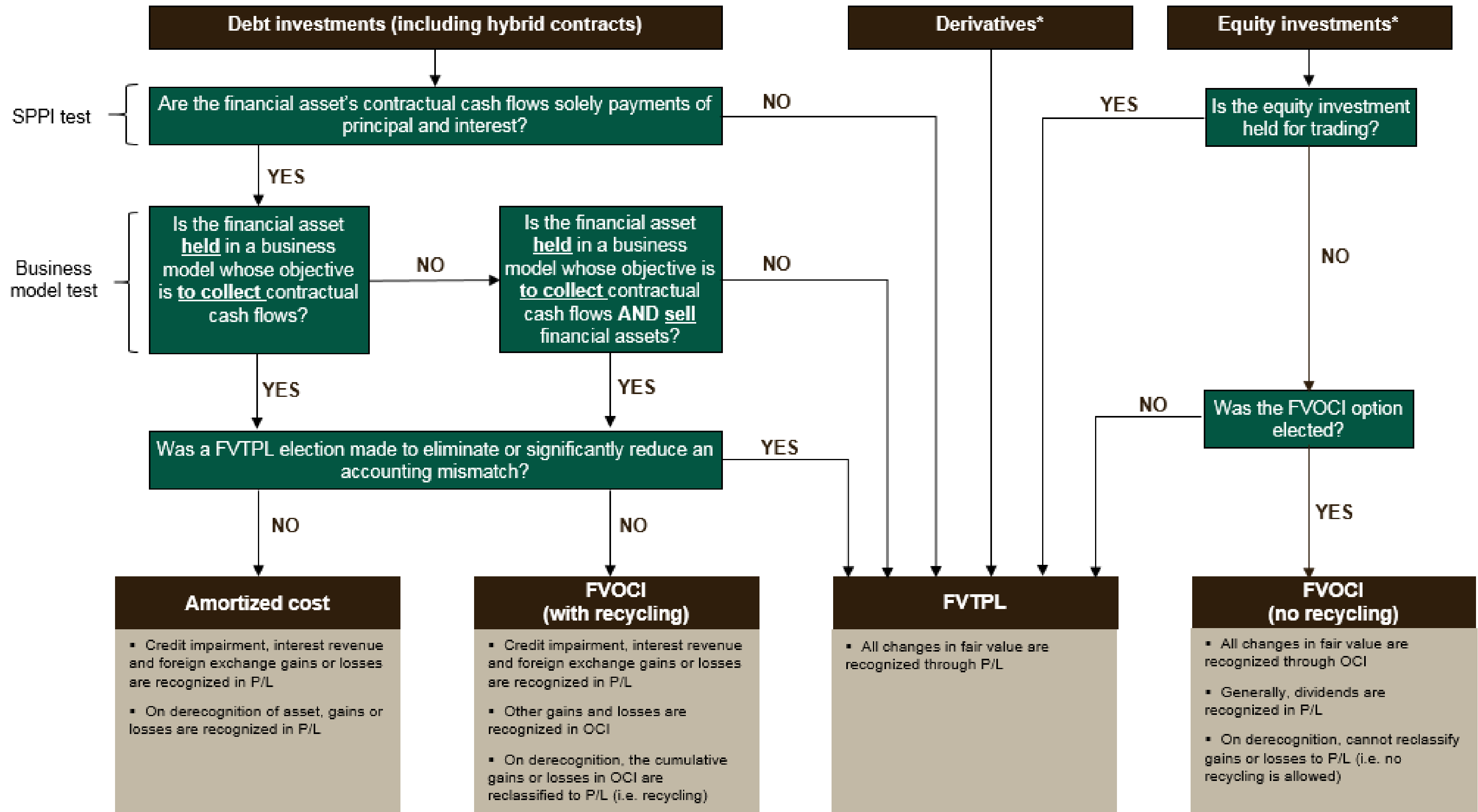
Appendix A: Classification and Measurement of FAs



* Assuming contractual terms of FA do not give rise on specified dates to CFs that are solely payments of principal and interest on the principal amount outstanding. This is generally the case for equity investments and derivatives; hence, we recommend this simplified approach to classification of these instruments.

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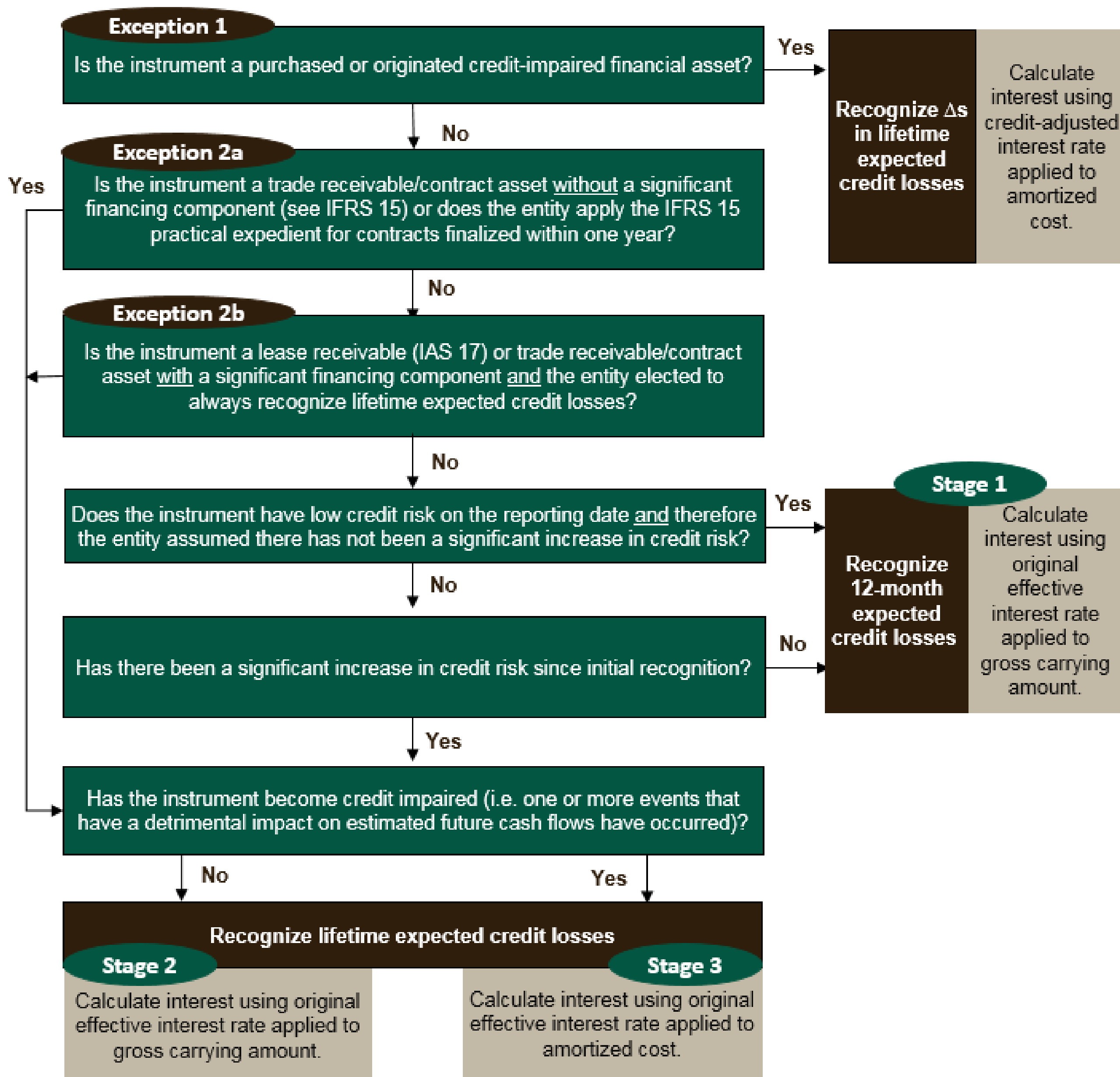
Appendix B: Impairment of Financial Assets



This communication contains a general overview of IFRS 9: Financial Instruments. This summary is not comprehensive and should be considered only in conjunction with review and consideration of the requirements of the relevant International Financial Reporting Standards. This information is current as at June 2015 and should not be regarded as a substitute for professional advice. MNP LLP accepts no responsibility or liability for any loss or damage caused by your reliance on information contained in this publication. Please contact your MNP representative for additional advice/guidance on a specific situation. © MNP LLP 2014. All Rights Reserved.