



THE ANANTROY BHATT KNOWLEDGE CENTRE



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Introduction to IFRS 9: Financial Instruments

IFRS 9 explains the classification and the measurement of financial instruments. Hence IFRS 9 helps to improve the information disclosure around financial instrument. Many perceived the information disclosure around financial instruments during the financial crisis as inaccurate. In short, impairments on financial instruments were taken too late and the amounts were too little.

IFRS 9 makes the classification of each financial instrument more logical and principal based. There are two questions which need to be answered for the classification:

- Why is the company holding the asset; just for collecting the cash flows from the underlying asset, or is the asset also held for trading?

- **What kind of asset is the financial asset? Is it a derivative, an equity or a debt instrument? With the SPPI (solely payment of principal and interest) model it can be tested whether an instrument is really a debt instrument.**

2

Classification & Measurement

As amended, IFRS 9 had four possible classification categories for financial assets, including a FVOCI classification for debt instruments. The classification is dependent on two tests, a contractual cash flow test (named SPPI as Solely Payments of Principal and Interest) and a business model assessment. Unless the asset meets the requirements of both tests, it is measured at fair value with all changes in fair value reporting in profit and loss (FVPL). In order to meet the contractual cash flow test, the cash flows from the instrument must consist of only principal and interest. Among the amendments to classification and measurement made in the 2014 update, de minimis and "non-genuine" features can be disregarded from the test, meaning that a de minimis feature would not preclude an instrument from being reported at amortized cost or FVOCI. However, equity instruments, derivatives and instruments that contain other than de minimis embedded derivatives would have to be reported at FVPL.

If the asset passes the contractual cash flows test, the business model assessment determines how the instrument is classified. If the instrument is being held to collect contractual cash flows, i.e., it is not expected to be sold, it is classified as amortized cost. If the business model for the instrument is to both collect contractual cash flows and potentially sell the asset, it is reported at FVOCI. For a FVOCI asset, the amortized cost basis is used to determine profit and loss, but the asset is reported at fair value on the balance sheet, with the difference between amortized cost and fair value reported in other comprehensive income. For any other business model, such as holding the asset for trading, the asset is reported at FVPL.

IFRS 9 retained most of the measurement guidance for liabilities from IAS 39, meaning most financial liabilities are held at amortized cost, the only change relating to liabilities that utilize the fair value option. For those liabilities, the change in fair value related to the entity's own credit standing is reported in other comprehensive income rather than profit and loss.

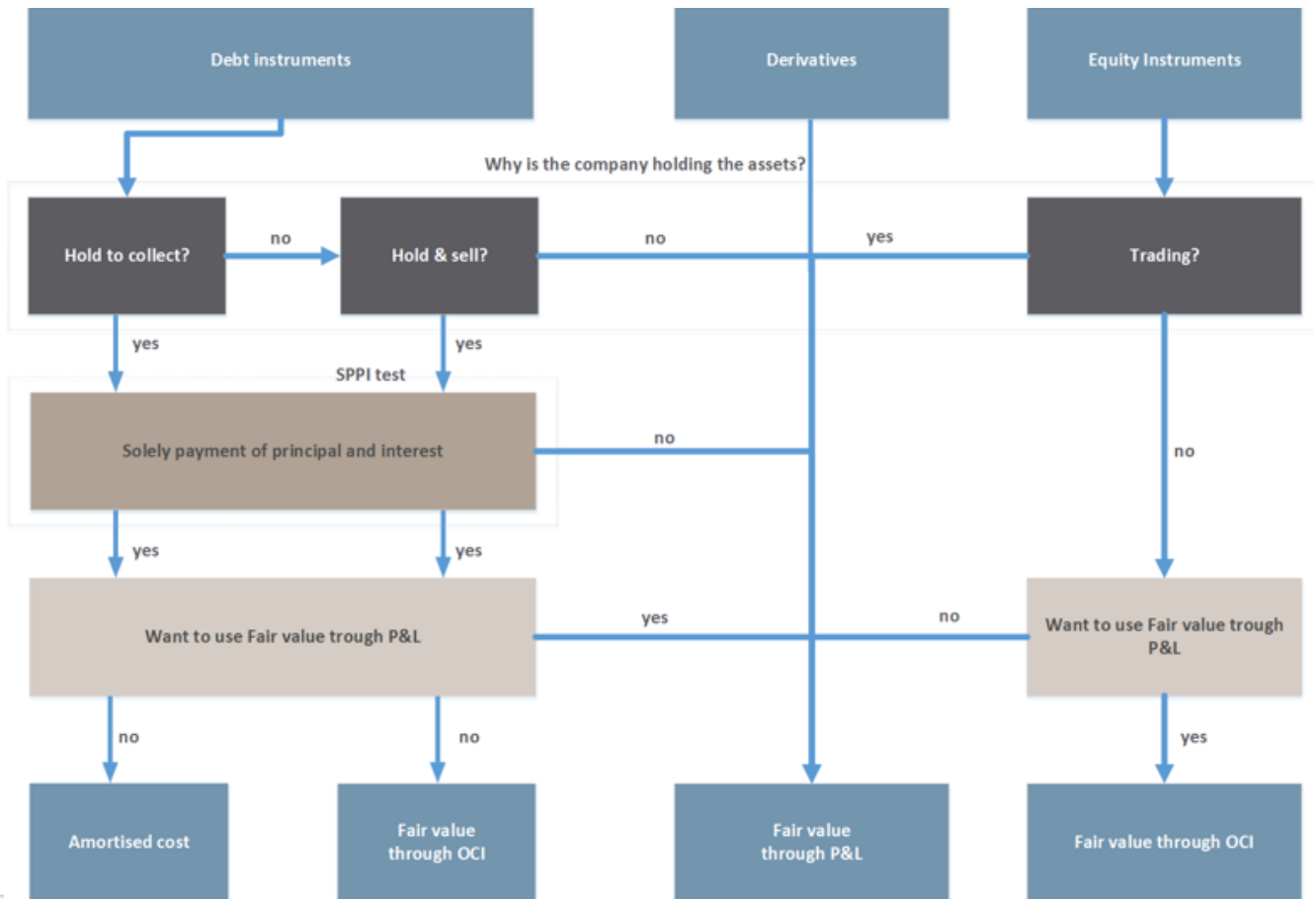
IFRS 9 retained the concept of fair value option from IAS 39, but revised the criteria for financial assets. Under a fair value option, an asset or liability that would otherwise be reported at amortized cost or FVOCI can use FVPL instead. IFRS 9 also incorporated a FVOCI option for certain equity instruments that are not held for trading. Under this option, the instrument is reported at FVOCI similar to FVOCI for debt. However, this version of FVOCI does not permit "recycling." Whereas when debt instruments using FVOCI are sold, the gain or loss on sale is "recycled" from other comprehensive income to profit and loss, for FVOCI equities the gain or loss is never reported in profit and loss, but rather remains in other comprehensive income.

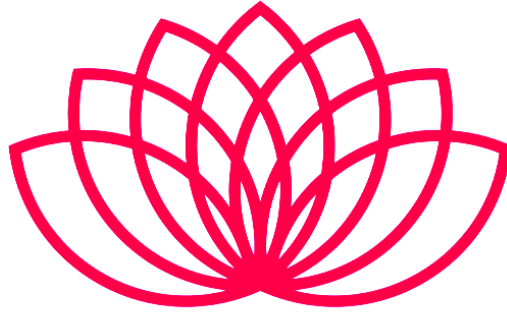
IFRS 9 requires an impairment allowance against the amortized cost of financial assets held at amortized cost or FVOCI. The change in this allowance is reported in profit and loss. For most such assets, when the asset is acquired the impairment allowance is measured as the present value of credit losses from default events projected over the next 12 months. The allowance will continue to be based on the expected losses from defaults on the receivables recognised at the balance sheet date in the next 12 months following, unless there is a significant increase in credit risk ("SICR"). If there is a significant increase in credit risk, the allowance is measured as the present value of all credit losses projected for the instrument over its full lifetime. If the credit risk recovers, the allowance can once again be limited to the projected credit losses over the following 12 months.

An exception to the general impairment model applies to financial assets that are credit impaired when they were originally acquired. For these assets, the impairment allowance is always based on the change in projected lifetime credit losses since the asset was acquired.

The new impairment model is intended to address a criticism of the impairment model used during the financial crisis, that it allowed companies to delay recognition of asset impairments. The new model requires companies to more quickly recognize projected lifetime losses. FASB elected to use a different approach to accelerating recognition of impairment losses, requiring full lifetime recognition from the time the asset is acquired, referred to as the Current Expected Credit Losses or CECL model. Under both IFRS 9 and the FASB model there will be a loss, to the extent of the allowance, when most assets covered by this guidance are acquired. This loss will be smaller under the IFRS 9 model, due to the 12 month limit.

IFRS 9 updated the guidance for hedge accounting. The intent was to "the accounting treatment with risk management activities, enabling entities to reflect better these activities in their financial statements." The changes also make it more feasible for non-financial entities to use hedge accounting. The changes permit more use of hedge accounting for components of instruments and groups of contracts, and ease the hedge effectiveness test. They also enhance the disclosures related to hedges and risk management with a requirement to refer to a formal risk management strategy or describe it clearly in the hedge documentation.





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www.anantbhattllp.com

CPA Kamal Anantroy Bhatt
Managing Partner
E : kamal@anantbhatt.com

CPA Daniel Kinyae Mumo
Associate Partner
E : daniel@anantbhatt.com

Anant Bhatt LLP
City House, First Floor
Nyerere Avenue
Mombasa, Kenya

P.O. Box 80766-80100
E : info@anantbhatt.com
P : 0726241555, 041-2223682, 041-2226542

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