IFRS 9
FINANCIAL INSTRUMENTS

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The final version of IFRS 9 *Financial Instruments* was issued in July 2014 and is the designated replacement of International Standards on Accounting ("IAS") 39 *Financial Instruments: Recognition and Measurement.* Similar to IFRS 15, IFRS 9 is one of the latest new pronouncements issued by the International Accounting Standards Board ("IASB") based in London that promulgates International Financial Reporting Standards ("IFRS"). IFRS 9 is effective for annual years commencing on or after 1 January 2018 and is a significant reform of IAS 39 which many users cited as complex. As such, IFRS 9 is founded on a simple and logical classification and measurement approach to record financial instruments.

IFRS 9 provides guidance as to the classification of financial instruments driven by their specific cash flow characteristics and the business model in which those financial instruments are held. In addition, a new single impairment model is introduced that may be applied to all financial instruments, whereas the predecessor standard, IAS 39, required a separate impairment model to be performed for the various types of financial instruments, including financial assets, financial liabilities, and equity instruments.

In addition, IFRS 9 is expected to result in more accurate and timely impairment charges based on new requirements under the expected credit losses guidance which lowers the threshold for recognition of full time expected losses.

Next, IFRS 9 significantly enhanced the guidance on hedge accounting with updated and detailed disclosures required on an entity's risk management, thereby enabling users of the audited financial statements to have information to assess the effectiveness of an entity's risk management strategy and possible hedging strategy as well.

The following are the three phases of the project summary of IFRS 9:

Phase 1: Classification and Measurement;

Phase 2: Impairment; and

Phase 3: Hedge Accounting.

In order to proceed on providing the more detailed requirements of IFRS 9, the following key definitions are set out, as sourced directly from the issued guidance by the International Accounting Standards Board.

Key definitions [IFRS 9: Appendix A]

Derecognition

The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.

Derivative

A financial instrument or other contract within the scope of IFRS 9 with all three of the following characteristics.

- Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');

- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factor; and

- It is settled at a future date.

Fair value

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.

Financial guarantee contract

A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Financial liability at fair value through profit or loss

A financial liability that meets either of the following conditions:

- It meets the definition of held for trading;
- Upon initial recognition it is designated by the entity as at fair value through profit or loss; or
- It is designated either upon initial recognition or subsequently as at fair value through profit or loss.

Firm commitment

A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

Forecast transaction

An uncommitted but anticipated future transaction.

Hedge ratio

The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.

Held for trading

A financial asset or financial liability that:

- Is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
- On initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
- Is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Reclassification date

The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.

Regular way purchase or sale

A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

The Classification and Measurement Approach

One of the core principle of IFRS is a classification approach to labelling financial instruments in order to determine their classification and measurement based primarily on the following:

1. The entity's business model for managing the financial instrument; and

2. The contractual cash flow characteristics of the financial instrument.

Initial measurement of financial instruments

All financial instruments are initially measured at fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs. [IFRS 9, paragraph 5.1.1]

Subsequent measurement of financial liabilities

IFRS 9 doesn't change the basic accounting model for financial liabilities under IAS 39. Two measurement categories continue to exist: FVTPL and amortised cost. Financial liabilities held for trading are measured at FVTPL, and all other financial liabilities are measured at amortised cost unless the fair value option is applied. [IFRS 9, paragraph 4.2.1]

Subsequent measurement of financial assets

IFRS 9 divides all financial assets that are currently in the scope of IAS 39 into two classifications - those measured at amortised cost and those measured at fair value.

Where assets are measured at fair value, gains and losses are either recognised entirely in profit or loss (fair value through profit or loss, FVTPL), or recognised in other comprehensive income (fair value through other comprehensive income, FVTOCI).

For debt instruments the FVTOCI classification is mandatory for certain assets unless the fair value option is elected. Whilst for equity investments, the FVTOCI classification is an election. Furthermore, the requirements for reclassifying gains or losses recognised in other comprehensive income are different for debt instruments and equity investments.

The classification of a financial asset is made at the time it is initially recognised, namely when the entity becomes a party to the contractual provisions of the instrument. [IFRS 9, paragraph 4.1.1] If certain conditions are met, the classification of an asset may subsequently need to be reclassified.

Debt instruments

A debt instrument that meets the following two conditions must be measured at amortised cost (net of any write down for impairment) unless the asset is designated at FVTPL under the fair value option: [IFRS 9, paragraph 4.1.2]

Business model test: The objective of the entity's business model is to hold the financial asset to collect the contractual cash flows (rather than to sell the instrument prior to its contractual maturity to realise its fair value changes).

Cash flow characteristics test: The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

A debt instrument that meets the following two conditions must be measured at FVTOCI unless the asset is designated at FVTPL under the fair value option as follows: [IFRS 9, paragraph 4.1.2A]

Business model test: The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

Cash flow characteristics test: The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

All other debt instruments must be measured at fair value through profit or loss (FVTPL). [IFRS 9, paragraph 4.1.4]

Fair value option

Even if an instrument meets the two requirements to be measured at amortised cost or FVTOCI, IFRS 9 contains an option to designate, at initial recognition, a financial asset as measured at FVTPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases. [IFRS 9, paragraph 4.1.5]

Equity instruments

All equity investments in scope of IFRS 9 are to be measured at fair value in the statement of financial position, with value changes recognised in profit or loss, except for those equity investments for which the entity has elected to present value changes in 'other comprehensive income'. There is no 'cost exception' for unquoted equities.

"Other comprehensive income" option

If an equity investment is not held for trading, an entity can make an irrevocable election at initial recognition to measure it at FVTOCI with only dividend income recognised in profit or loss. [IFRS 9, paragraph 5.7.5]

Measurement guidance

Despite the fair value requirement for all equity investments, IFRS 9 contains guidance on when cost may be the best estimate of fair value and also when it might not be representative of fair value.

Subsequent measurement of financial liabilities

IFRS 9 doesn't change the basic accounting model for financial liabilities under IAS 39. Two measurement categories continue to exist: FVTPL and amortised cost. Financial liabilities held for trading are measured at FVTPL, and all other financial liabilities are measured at amortised cost unless the fair value option is applied. [IFRS 9, paragraph 4.2.1]

Hedged items

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation and must be reliably measurable. [IFRS 9 paragraphs 6.3.1-6.3.3]

An aggregated exposure that is a combination of an eligible hedged item as described above and a derivative may be designated as a hedged item. [IFRS 9 paragraph 6.3.4]

The hedged item must generally be with a party external to the reporting entity, however, as an exception the foreign currency risk of an intragroup monetary item may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. [IFRS 9 paragraphs 6.3.5 -6.3.6]

Impairment

The impairment model in IFRS 9 is based on the premise of providing for expected losses.

Scope

IFRS 9 requires that the same impairment model apply to all of the following: [IFRS 9 paragraph 5.5.1]

- Financial assets measured at amortised cost;
- Financial assets mandatorily measured at FVTOCI;
- Loan commitments when there is a present obligation to extend credit (except where these are measured at FVTPL);
    - Financial guarantee contracts to which IFRS 9 is applied (except those measured at FVTPL);
    - Lease receivables within the scope of IAS 17 *Leases*; and
    - Contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers* (i.e. rights to consideration following transfer of goods or services).

General approach

With the exception of purchased or originated credit impaired financial assets (see below), expected credit losses are required to be measured through a loss allowance at an amount equal to:
[IFRS 9 paragraphs 5.5.3 and 5.5.5]

- the 12-month expected credit losses (expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date); or
- full lifetime expected credit losses (expected credit losses that result from all possible default events over the life of the financial instrument).

A loss allowance for full lifetime expected credit losses is required for a financial instrument if the credit risk of that financial instrument has increased significantly since initial recognition, as well as to contract assets or trade receivables that do not constitute a financing transaction in accordance with IFRS 15. [IFRS 9 paragraphs 5.5.3 and 5.5.15]

Additionally, entities can elect an accounting policy to recognise full lifetime expected losses for all contract assets and/or all trade receivables that do constitute a financing transaction in accordance with IFRS 15. The same election is also separately permitted for lease receivables. [IFRS 9 paragraph 5.5.16]

For all other financial instruments, expected credit losses are measured at an amount equal to the 12-month expected credit losses. [IFRS 9 paragraph 5.5.5]

Significant increase in credit risk

With the exception of purchased or originated credit-impaired financial assets (see below), the loss allowance for financial instruments is measured at an amount equal to lifetime expected losses if the credit risk of a financial instrument has increased significantly since initial recognition, unless the credit risk of the financial instrument is low at the reporting date in which case it can be assumed that credit risk on the financial instrument has not increased significantly, as defined as a change that could impact a user's decision, since initial recognition. [IFRS 9 paragraphs 5.5.3 and 5.5.10]

IFRS 9 also considers credit risk low if there is a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations.
IFRS 9 suggests that "investment grade" rating might be an indicator for a low credit risk. [IFRS 9 paragraphs B5.5.22 – B5.5.24]

The assessment of whether there has been a significant increase in credit risk is based on an increase in the probability of a default occurring since initial recognition. Under the Standard, an entity may use various approaches to assess whether credit risk has increased significantly (provided that the approach is consistent with the requirements). An approach can be consistent with the requirements even if it does not include an explicit probability of default occurring as an input. The application guidance provides a list of factors that may assist an entity in making the assessment. Also, whilst in principle the assessment of whether a loss allowance should be based on lifetime expected credit losses is to be made on an individual basis, some factors or indicators might not be available at an instrument level. In this case, the entity should perform the assessment on appropriate groups or portions of a portfolio of financial instruments.

The requirements also contain a rebuttable presumption that the credit risk has increased significantly when contractual payments are more than 30 days past due. IFRS 9 also requires that (other than for purchased or originated credit impaired financial instruments) if a significant increase in credit risk that had taken place since initial recognition and has reversed by a subsequent reporting period (i.e., cumulatively credit risk is not significantly higher than at initial recognition) then the expected credit losses on the financial instrument revert to being measured based on an amount equal to the 12-month expected credit losses. [IFRS 9 paragraph 5.5.11]

Presentation

Whilst interest revenue is always required to be presented as a separate line item, it is calculated differently according to the status of the asset with regard to credit impairment. In the case of a financial asset that is not a purchased or originated credit-impaired financial asset and for which there is no objective evidence of impairment at the reporting date, interest revenue is calculated by applying the effective interest rate method to the gross carrying amount. [IFRS 9 paragraph 5.4.1]

In the case of a financial asset that is not a purchased or originated credit-impaired financial asset but subsequently has become credit-impaired, interest revenue is calculated by applying the effective interest rate to the amortised cost balance, which comprises the gross carrying amount adjusted for any loss allowance. [IFRS 9 paragraph 5.4.1]

In the case of purchased or originated credit-impaired financial assets, interest revenue is always recognised by applying the credit-adjusted effective interest rate to the amortised cost carrying amount. [IFRS 9 paragraph 5.4.1]

The credit-adjusted effective interest rate is the rate that discounts the cash flows expected on initial recognition (explicitly taking account of expected credit losses as well as contractual terms of the instrument) back to the amortised cost at initial recognition. [IFRS 9 Appendix A]

KANAAN & ASSOCIATES COMMENTS ON IFRS 9

While we welcome the detailed guidance on accounting for the veracious financial instruments, including useful disclosure requirements, significant effort is required by entities in the United Arab Emirates, in particular SMEs, in order to fully implement IFRS 9 and we welcome the opportunity to open the discussion as to how we can help in this regard.

Contact Us

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