



BASICS ABOUT ACCOUNTING

SUPPLEMENT MATERIAL FOR:

**ACCOUNTING
CASE STUDIES**



Basics about Accounting

The following pages provide an insight into the accounting for financial instruments. The financial instruments have been the most complex and controversial area of the accounting. The dynamic and completely globalised development of the international financial markets has resulted in a great variety of financial instruments from traditional cash, debt and equity instruments to derivative instruments such as options, futures and swaps to synthetic instruments. The impact on the financial statements is great and regulation is extremely important.

The global financial crisis of 2008 and 2009 very clearly indicated how much the financial markets are interconnected. The failure of a single market led to the collapse of the whole financial system of the developed world. The financial instruments had a “key role” in the crisis. It became essential that the global market players especially the financial institutions provide adequate information.

Therefore, the accounting regulation of financial instruments received a special attention from the regulatory bodies.

IFRS 9 *Financial Instruments* has been developed by the International Accounting Standards Board (IASB) to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The IASB completed IFRS 9 in July 2014, by publishing a final standard which incorporates the final requirements of all three phases of the financial instrument projects, being:

- Classification and Measurement,
- Impairment, and
- Hedge Accounting.

IFRS 9 generally is effective for years beginning on or after January 1, 2018, with earlier adoption permitted. However, in late 2016 the IASB agreed to provide entities whose predominate activities are insurance related the option of delaying implementation until 2021.

Convergence with US GAAP

The IASB’s project was initially carried out as a joint project with the US Financial Accounting Standards Board (FASB). However, the FASB ultimately decided to make more limited changes to the classification and measurement of financial instruments, and to develop a more US specific impairment model for financial assets.



At this moment the accounting of the financial instruments is regulated by the following specific standards:

- IAS 32 Financial instruments: Presentation
- IFRS 9 Financial instruments
- IFRS 7 Financial instruments: Disclosures

IAS 32 provides definitions for financial instrument, cash, financial liability, equity instrument. This standard provides a guideline on whether a financial instrument is considered a financial asset or financial liability or an equity instrument or whether it is a compound instrument that consists of both liability and equity components. The standard also addresses some presentation topics as well.

IAS 9 provides recognition and measurement requirements for financial assets and financial liabilities.

IFRS 7 requires entities to provide information that enable users of the financial statements to evaluate the significance of financial instruments for the entity's financial position and performance, and the nature and extent of risks arising from financial instruments to which an entity is exposed.

This paper is dealing with IFRS 9 and special attention is given to the classification and measurement issues.



Classification and measurement

Definitions

Financial instrument is any contract that gives rise to a financial asset of one entity, and a financial liability or equity instrument of another entity. This means that items that will be settled through the receipt or delivery of goods or services are not financial instruments, nor typically are tax assets and liabilities as these arise legally. However, contracts to buy or sell commodities or non-financial assets in the future are accounted for as derivatives if certain criteria are met.

Derivative is a financial instrument or other contract with all three of the following characteristics:

- its value changes in response to one or more underlying variables (e.g. interest rate, security price, foreign exchange price, index of prices or rates);
- it requires little or no initial net investment ;
- it will be settled at a future date.

Effective interest method is a method of calculating the amortization cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period.

Amortization cost of financial asset or financial liability. Amortised cost measurement can apply to both financial assets and financial liabilities. The effective interest method is used for amortising premiums, discounts and transactions costs. Interest is recognised in profit or loss in the period to which it relates.



CLASSIFICATION

Classification of financial assets

Under IFRS 9 financial assets are classified into one of *three primary measurement categories*:

- amortised cost
- fair value through other comprehensive income (FVOCI)
- fair value through profit or loss (FVTPL).

In addition, IFRS 9 provides an *option* on initial recognition only, irrevocably to *designate* financial assets that would otherwise be measured at amortised cost or fair value through other comprehensive income under IFRS 9's general principles at fair value through profit or loss, if this designation would reduce or eliminate a so-called 'accounting mismatch. (Fair value option).

The designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets (or liabilities), or from recognising the gains and losses on them, using different bases ("accounting mismatch").

The *classification* is determined by *both*:

- 1) the entity's business model for managing the financial asset ('business model test'); and
- 2) the contractual cash flow characteristics of the financial asset ('cash flow characteristics test').

1) Business model test

Looking at the first of the two classification criteria, IFRS 9 uses the term 'business model' in terms of how financial assets are managed and the extent to which cash flows will result from collecting contractual cash flows, selling financial assets or both.

The business model should be determined by considering all relevant factors, which might include:

- how performance is evaluated and reported to the entity's key management personnel;
- the risks affecting performance of the business model and how those risks are managed;
- how managers of the business are compensated (e.g. whether compensation is based on fair value of assets managed or on contractual cash flows).



The objective of the entity's business model is not based on management's intentions to an individual instrument, it is determined at a higher level of aggregation. An entity may follow more than one business model for managing its financial instruments.

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

Business model	Objectives of the business model	Category
Held-to-collect	To hold assets to collect the contractual cash flows Sales are incidental	Amortised cost
Held-to collect and for sale	Both collecting cash flows and sales of the financial asset More sales (in frequency and volume)	FVOCI
Other - trading, managing assets on a fair value basis	Active trading	FVTPL

Held-to-collect business model

To qualify for amortised cost classification, the financial asset must be in a 'held-to-collect' business model. The entity's main objective is to hold the financial asset to collect the contractual cash flows from the financial asset over the instruments' lives, rather than to sell the asset to realise a profit or loss. For example, trade receivables held by a manufacturing entity are likely to fall within the 'held-to-collect' business model, as the manufacturing entity is likely to have the intention to collect the cash flows from those trade receivables.

The 'held-to-collect' business model does not require that financial assets are always held until their maturity. An entity's business model can still be to hold financial assets to collect contractual cash flows, even when sales of financial assets occur. However, if more than an infrequent number of sales are made out of a portfolio, the entity should assess whether and how the sales are consistent with the 'held-to-collect' objective. This assessment should include the reason(s) for the sales, the expected frequency of sales, and whether the assets that are sold are held for an extended period of time relative to their contractual maturities.

Therefore, in determining whether cash flows are going to be realised by collecting the financial assets' contractual payments, it is necessary to consider:

- the *frequency, volume* and *timing* of sales in prior periods
- the reasons for those sales and
- expectations about future sales activity.



Both held to collect and for sales business mode

In this case selling of financial asset occurs more frequently and in higher amount than in a held-to-collect business model. However, there is no benchmark for the frequency or amount of sales, because both activities are integral to achieving its aims.

Other business model

Financial assets held in any other business model are measured at FVTPL. This category includes a portfolio that:

- held for trading (acquired originally and principally for trading in the near term, active and frequent buying and selling of an item);
- managed and whose performance is evaluated on a fair value basis;
- managed with the objective of realising cash flows through sale.

2) Cash flow characteristics test

The requirements is that the contractual terms of the financial asset give rise to cash flows that are *solely payments of principal and interest (SPPI)* on the principal amount outstanding on a specified date.

Principal is the fair value of the financial asset at initial recognition. Principal may change over the time, e.g. because of the repayments of the principle.

Interest consists of consideration for:

- the time value of money
- the credit risk associated with the principal amount outstanding during a particular period
- other basic lending risks (e.g. liquidity risk and costs (e.g. administrative costs) and
- a profit margin



Contractual cash flows that meet the SPPI criterion should be consistent with a basic lending arrangement. Therefore contractual features that include other risks elements (like equity or commodity prices etc.) do not meet the SPPI criterion.

Similarly contracts that increase leverage fail the test as they increase the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Forward and swap contracts are other examples of financial assets that include such leverage. As a result, derivatives always 'fail' the solely payments of principal and interest test and must be classified in the fair value through profit or loss category.

The time value of money represents the element of interest that provides consideration for the passage of time (it does not provide consideration for any other risks or costs associated with the asset).

From the point of SPPI test the types of the relevant interest rates can be the following:

- fixed interest rate that ensures predetermined cash flows;
- variable interest rate linked to a market based interest rate (e.g. LIBOR, EURIBOR);

At the same time interest rate linked to other sort of market indicators (e.g. a stock market index) cannot be considered as acceptable for SPPI purposes. In such cases when cash flows are indexed to the debtor's performance (e.g. revenue or net income) the contract would reflect a return. That is inconsistent with the basic lending agreement and would not meet the SPPI criterion.

- the combination of above two: market based interest rate and a fixed interest premium (e.g. LIBOR + 3%).

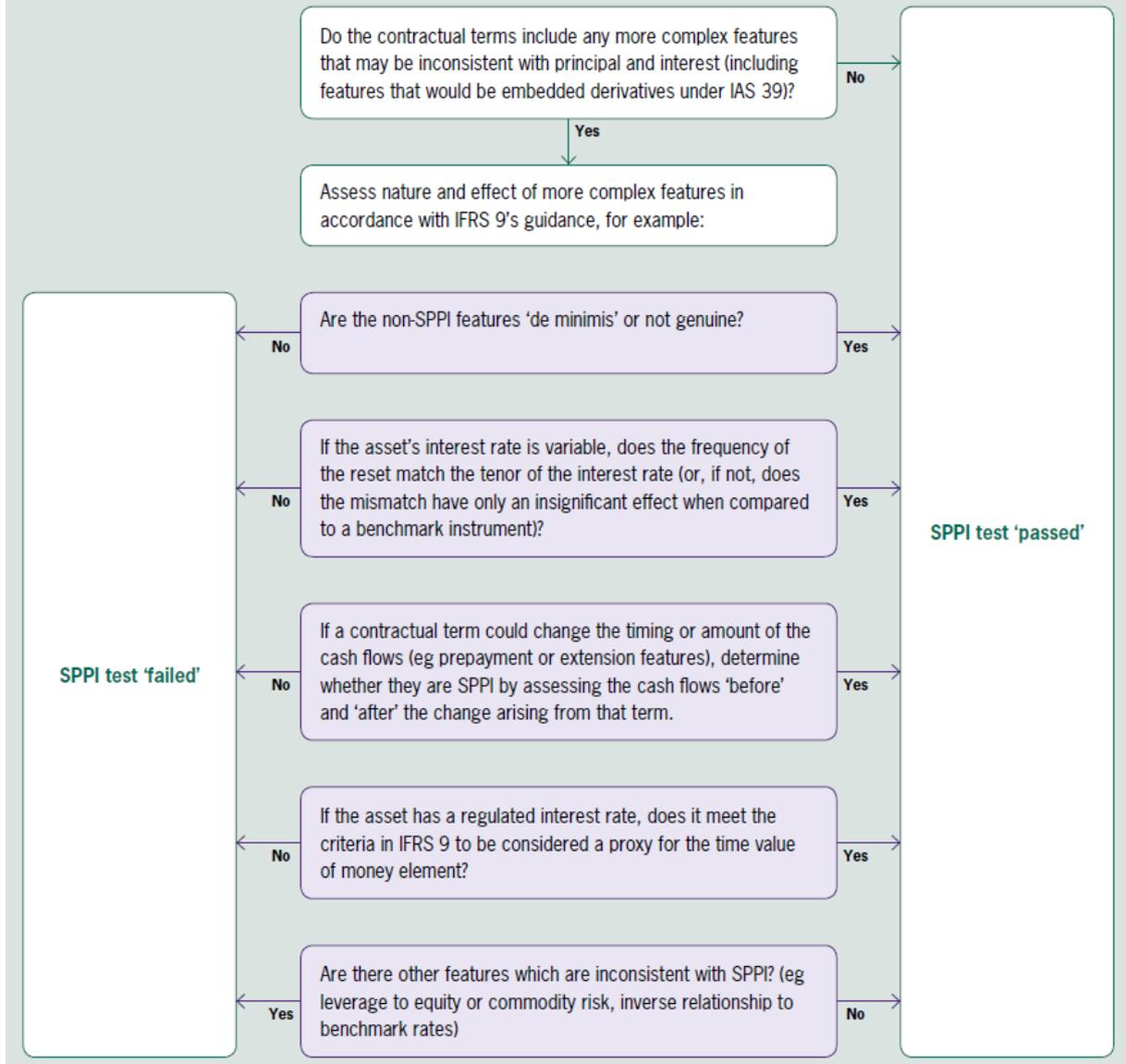
A special case of this combination is if there is an agreement, that market interest rate is limited from above or under (cap or floor). This fulfils the requirement of the standard.

Contractual cash flow terms that have only 'a de minimis' effect on the contractual cash flows of a financial asset does not affect classification. In the case of contingent cash flows this relates to the amount of the cash flows not the probability that they would occur. To make this determination, an entity considers the possible effect on the contractual cash flow characteristic in each accounting period and cumulatively over the life of the financial asset.

Also if there is a characteristic of the contractual cash flow is 'not genuine' there is no need for classification.

Applying the 'solely payments of principal and interest' test

As discussed in the sections above, IFRS 9 provides extensive guidance on the solely payments of principal and interest (SPPI) test. The following diagramme visually summarises some of the matters to consider when evaluating whether an asset meets the solely payments of principal and interest test.



Source: Grant and Thornton, Get ready for IFRS 9 Classifying and measuring financial instruments, 1 November 2015, page 20



MEASUREMENT OF FINANCIAL ASSETS

Initial recognition

All financial instruments are *initially* measured *at fair value*, adjusted for transaction cost for instruments not carried at fair value. For financial instruments that will subsequently measure at fair value, transaction costs are recognized in profit and loss.

The fair value of financial instruments is determined in accordance with IFRS 13.

Transaction costs include only those costs that are directly attributable to the acquisition or origination of a financial asset or issue of a financial liability. They are incremental costs. For financial assets, transaction costs are added to the amount initially recognized, whereas for financial liabilities transaction costs are deducted from the amount initially recognised. Some examples for transaction costs: fees and commissions paid for agents, brokers, credit assessment fees, registration charges. Transaction costs do not include debt premiums or discounts, financing cost or internal administrative and marketing costs.

Subsequent recognition

Amortised cost

A financial asset is classified as subsequently measured at amortised cost if it meets both of the following criteria:

- Held-to-collect business model test; and
- SPP' contractual cash flow characteristics test

Examples of financial instruments that are likely to be classified and accounted for at amortised cost include: trade receivables, loan receivables with 'basic' features, investments in government bonds that are not held for trading, investments in term deposits at standard interest rate.



Fair value through other comprehensive income (FVOCI)-Debt instruments

A *debt instrument* is measured at fair value through other comprehensive income, where *both* of the following are met:

- the held-to-collect *and* sell business model
- the SPPI contractual cash flow characteristics test

Examples of financial instruments that may be classified and accounted for at FVOCI include: investments in government bonds where the investment period is likely to be shorter than maturity, investments in corporate bonds where the investment period is likely to be shorter than maturity.

Fair value through other comprehensive income (FVOCI)-Equity instruments - Option

Investments in equity instruments *fail the SPPI test*; therefore they need to be measured at fair value through profit or loss. IFRS 9 however contains an exception to this rule. An entity may on initial recognition make an irrevocable election to present other comprehensive income the changes in the fair value of an equity instrument that is not held for trading.

Furthermore, in contrast to the fair value through other comprehensive income category for debt instruments gains and losses recognised in other comprehensive income are not subsequently transferred to profit or loss (sometimes referred to as 'recycling'), although the cumulative gain or loss may be transferred within equity. Where this election is made, dividends are still recognised in profit or loss.

Fair value through profit or loss (FVTPL)

Financial assets that do not meet the criteria for classification for being measured at either amortised cost or fair value through other comprehensive income are measured at fair value through profit or loss.

Examples of financial instruments that may be classified and accounted for at FVTPL include:

held-for-trading financial assets, investments in shares of listed companies that the entity has not elected to account for as at FVOCI, derivatives that have not been designated in a hedging relationship, e.g.: Interest rate swaps, commodity futures/option contracts, etc.



CLASSIFICATION AND MEASUREMENT OF FINANCIAL LIABILITY

Subsequent to initial recognition there are two main classification categories for financial liabilities:

- amortised cost
- fair value through profit or loss (FVTPL)

Financial liabilities measured at fair value through profit or loss can be divided into the following sub-categories:

- financial liabilities held for trading
- financial liabilities *designated* through profit or loss on inception

There is an *option*, on inception, designate financial liabilities at fair value through profit or loss in where it provides more relevant information.

Example

Company “B” has financial assets and financial liabilities that share a particular risk, such that their fair values change in opposite directions, tending to offset each other. However:

- only some of the instruments are measured at FVTPL, (derivatives, and those that are held for trading);
- hedge accounting cannot be applied, for example, the hedge effectiveness requirements are not met; or
- even though hedge accounting is applicable, hedge documentation is too onerous.

This company concludes that the *accounting mismatch* arises from the above circumstances, and therefore, to solve this problem, these financial assets and financial liabilities qualify for designation as at FVTPL. (IFRS 9.B4.1.30)

Gains or losses on financial liabilities measured by amortised cost are recognised in profit or loss, when the financial liability is derecognised, and through amortisation using the effective interest method.

Gains or losses on financial liabilities measured at fair value, are generally recognised in profit and loss. Except for certain financial liabilities designated as at FVTPL, when the entity is required to present the effects of changes in the liability’s credit risk in OCI.



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