

# Financial Instruments

Breaking the code of IFRS 9

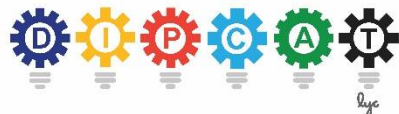
# Agenda

Why is this relevant?

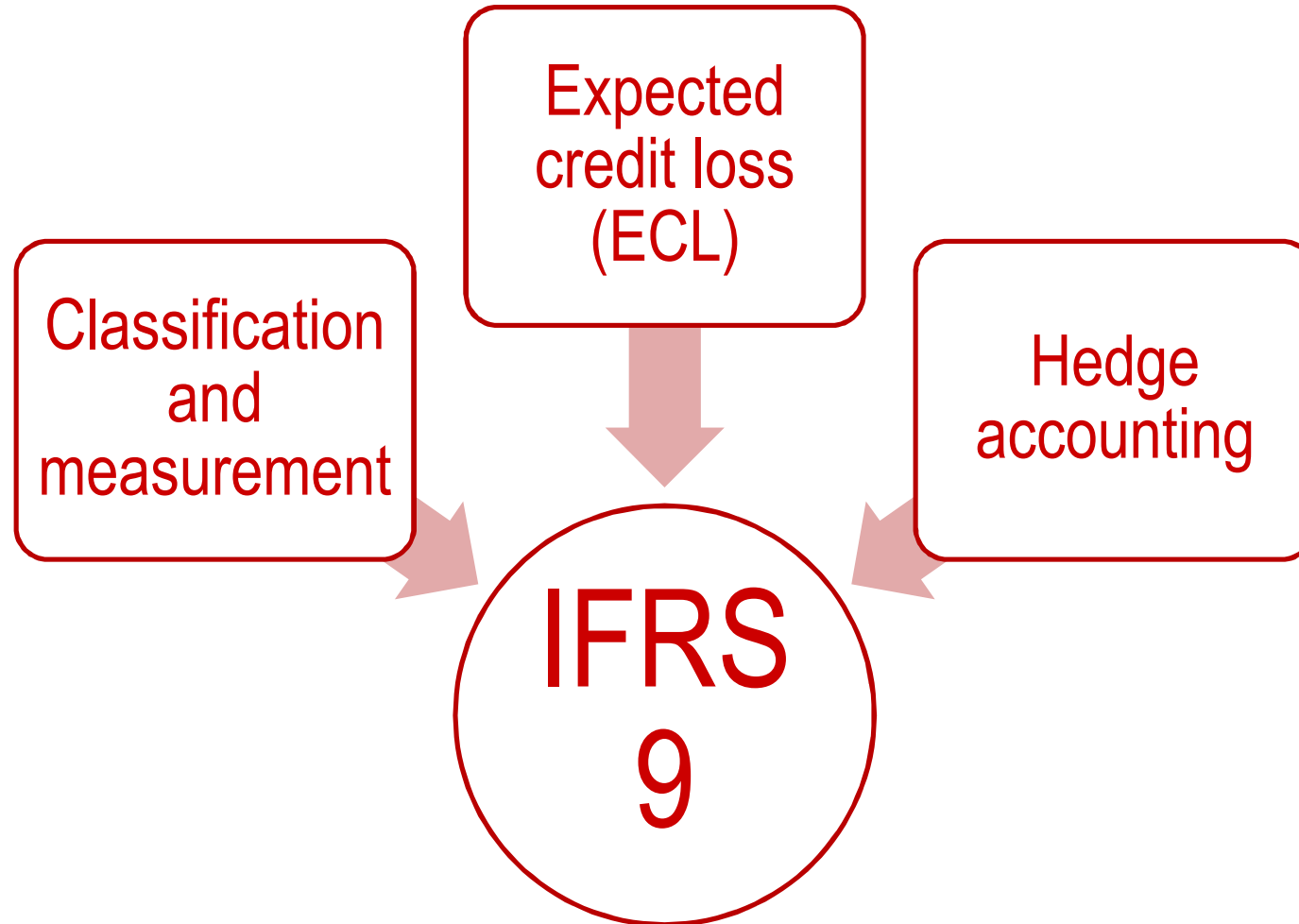
Definitions

Classification of financial assets

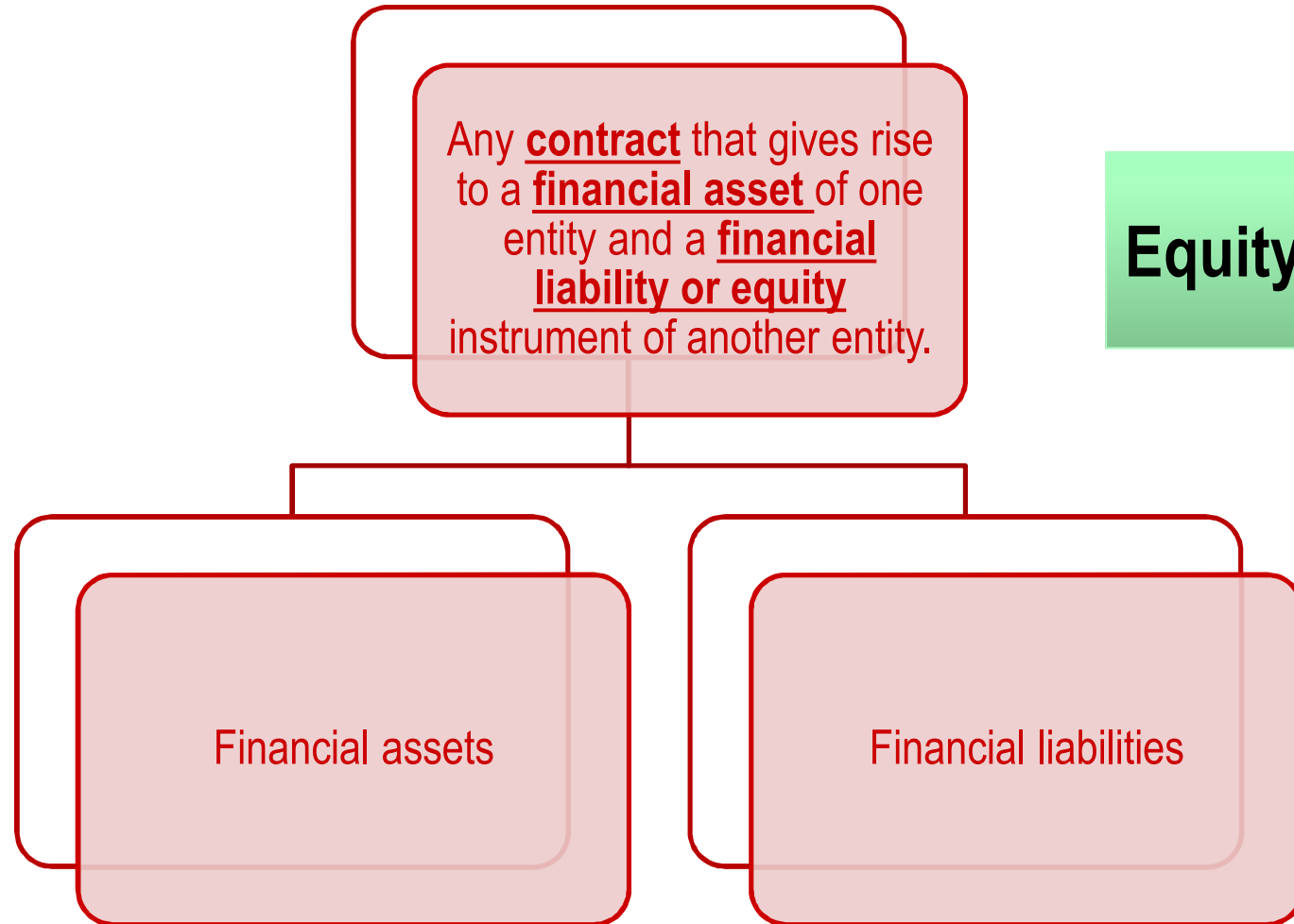
Measurement rules



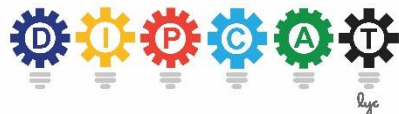
# IFRS 9 – the phases



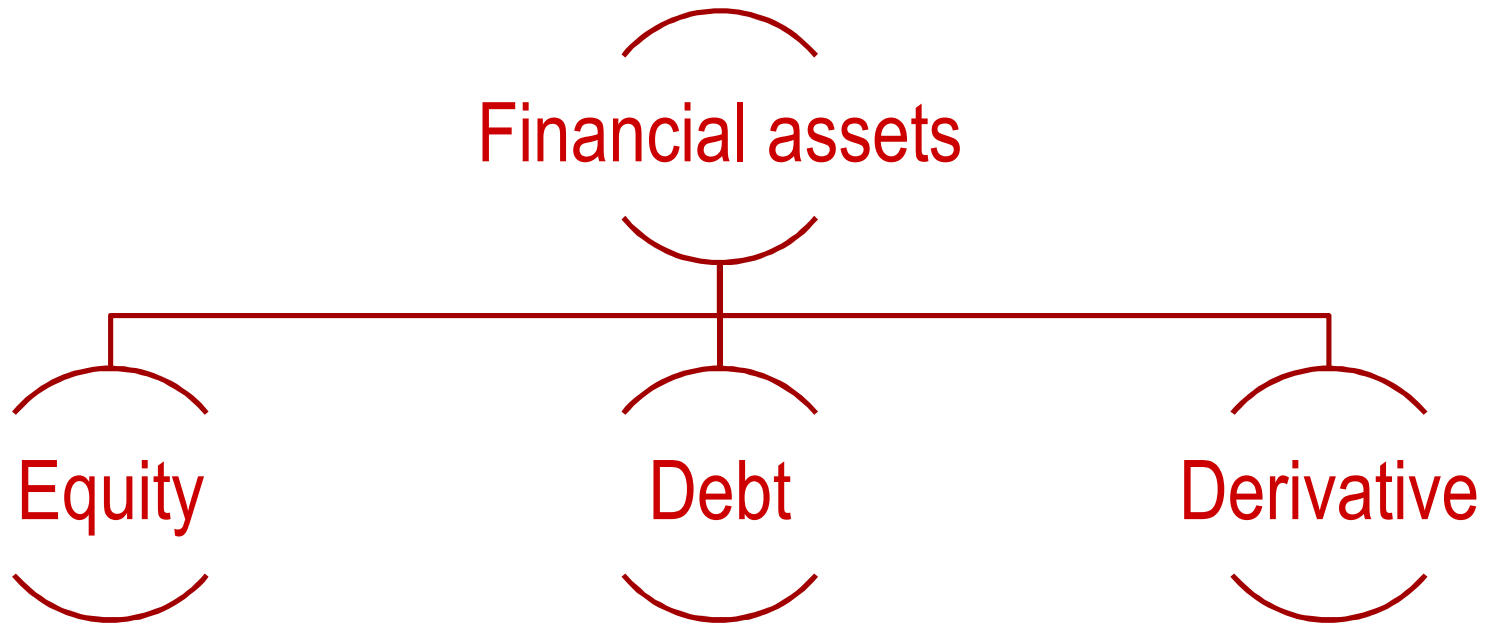
# Definitions



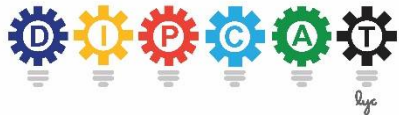
**Equity items**



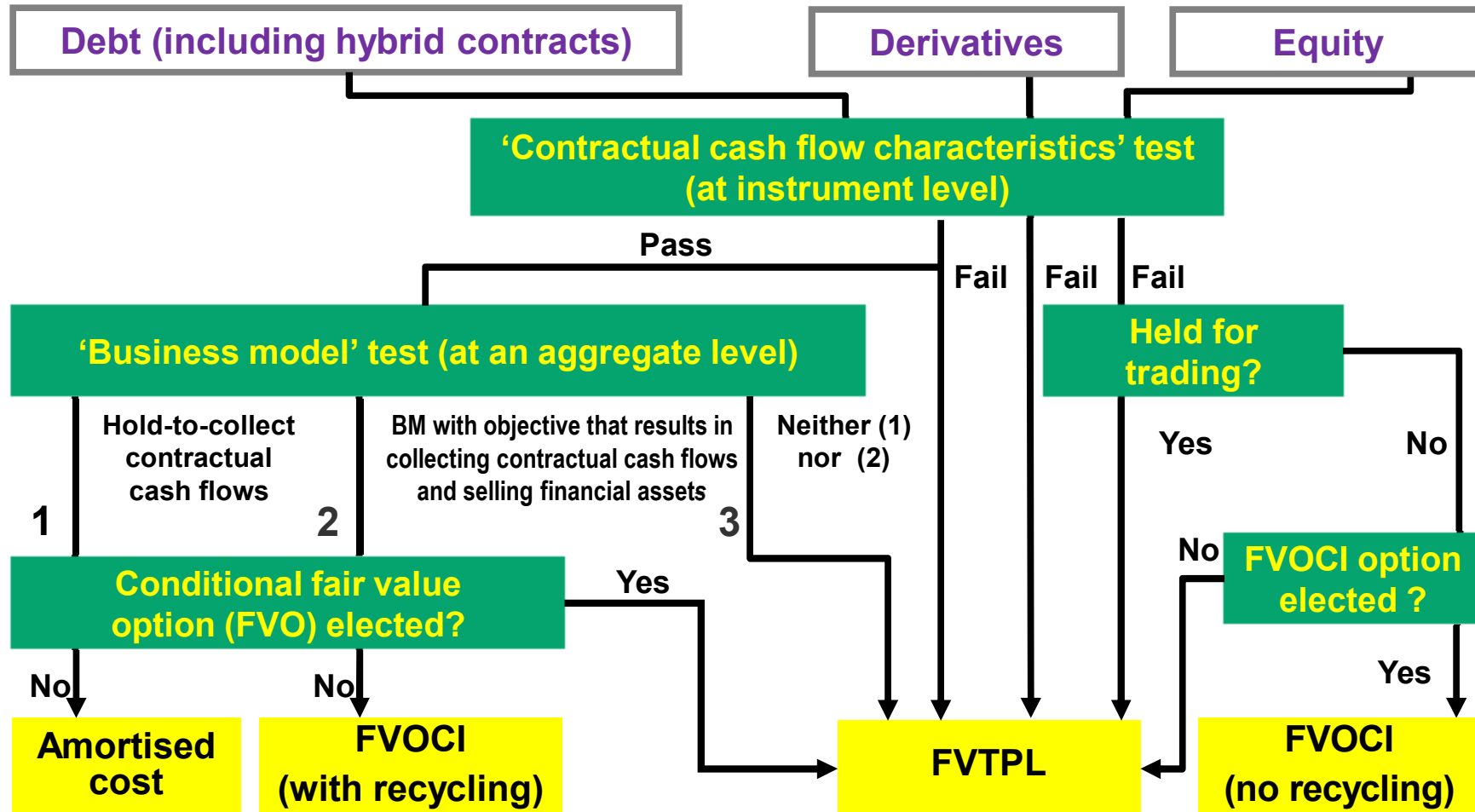
# Subgroups – financial assets



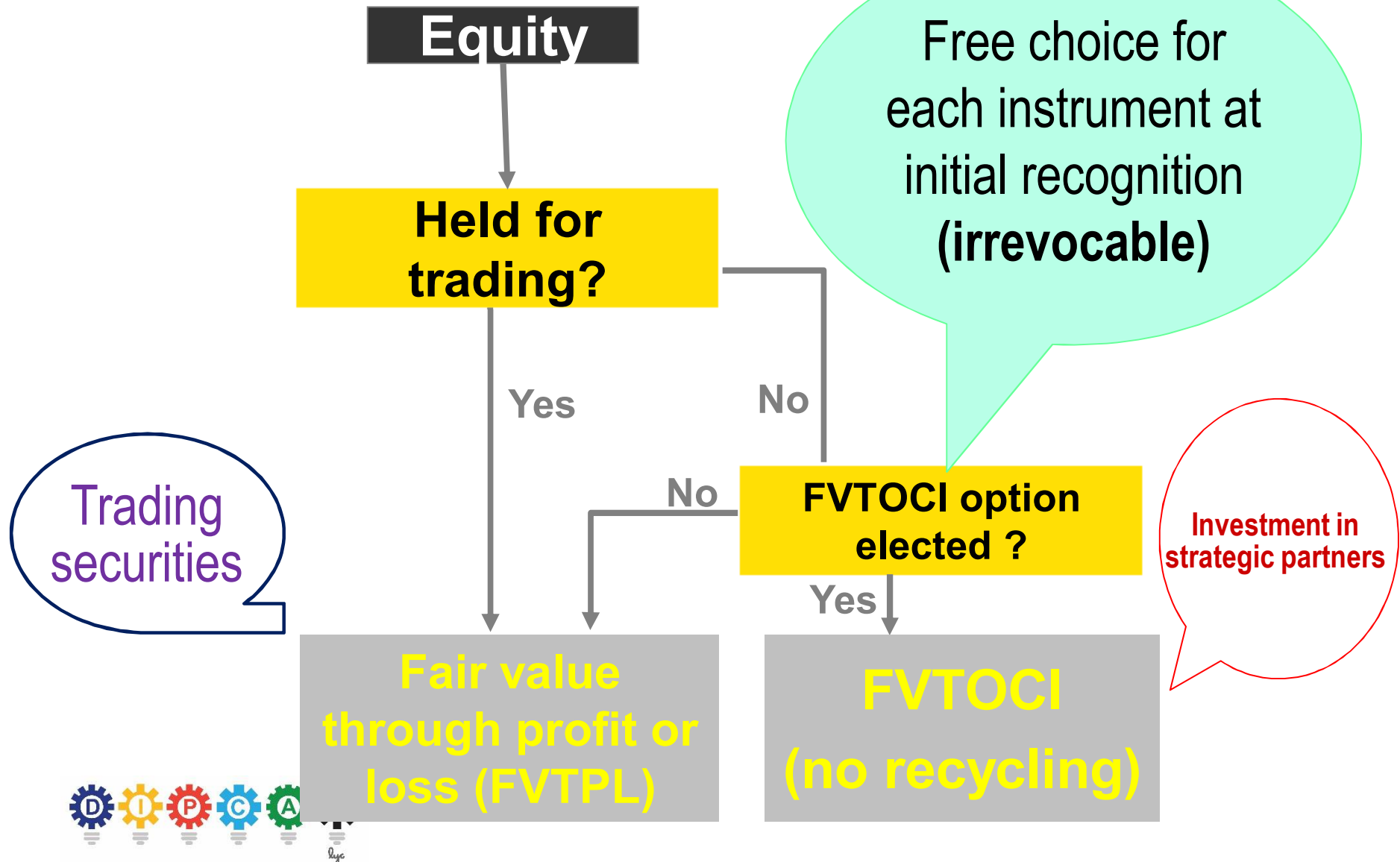
Meaning...?



# Classification



# Classification and measurement: Equity investments



# Measurement basis – fair value – issues

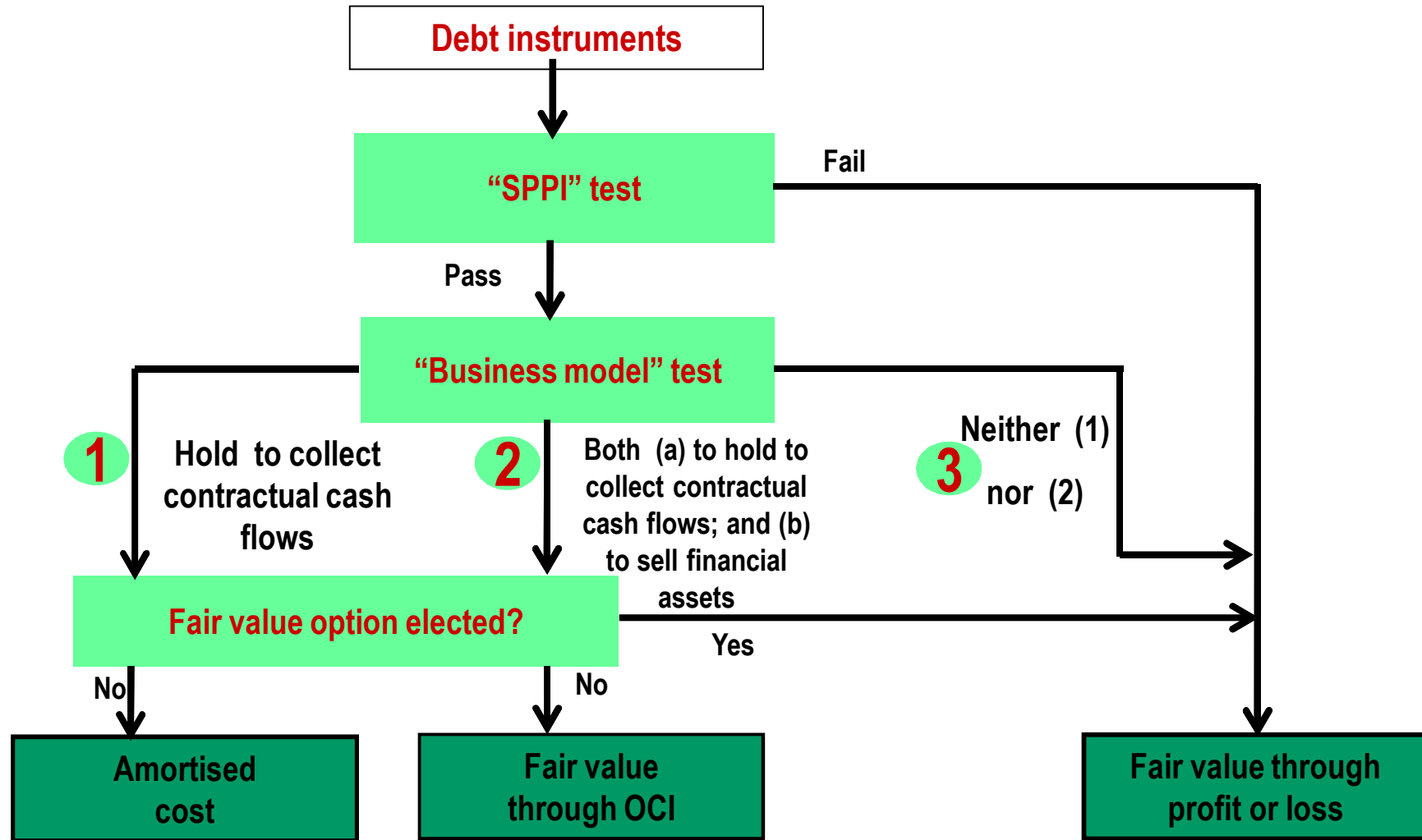
FVTPL

FVTOCI

Recycling



# Financial assets that are neither derivatives nor equity instruments

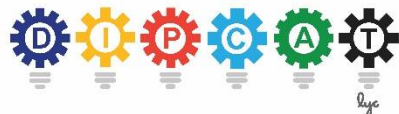


## Key factors that drive the business model assessment

- **Objective** of the business model as a matter of fact based on relevant information and reasonably possible scenarios
  - Performance evaluation
  - Risk management
  - Remuneration
- **Sales**, specifically reasonable expectations about future sales, for example factoring resulting in derecognition

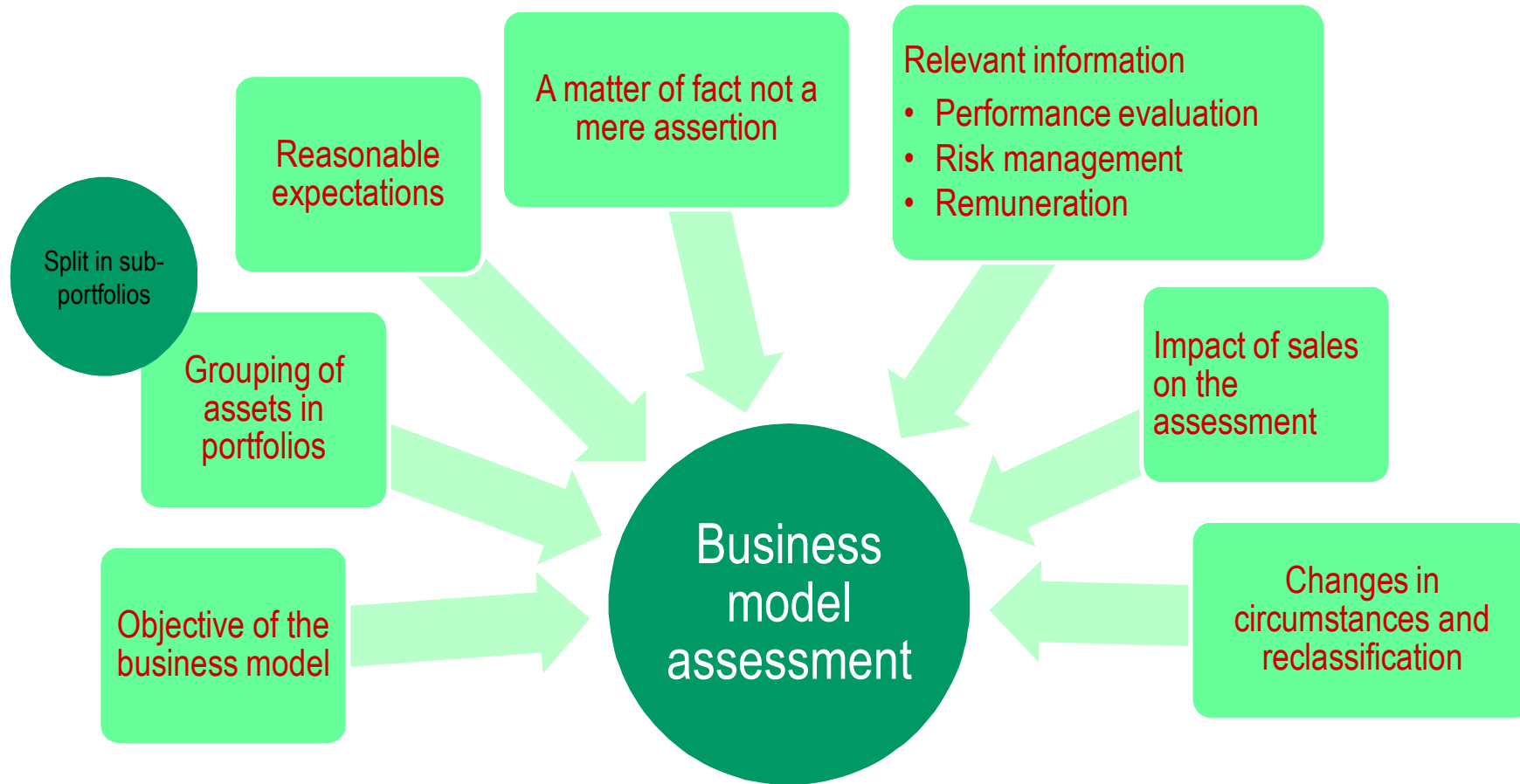
## Grouping of assets in portfolios

- One contract may contain several assets

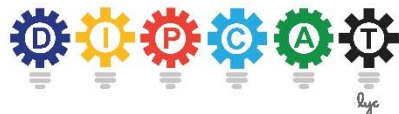


# Business model test

Factors to consider



Business model test is a **portfolio approach** and it is up to the entity to define at what level to group assets.

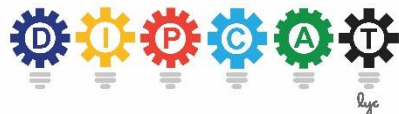


# Business model test

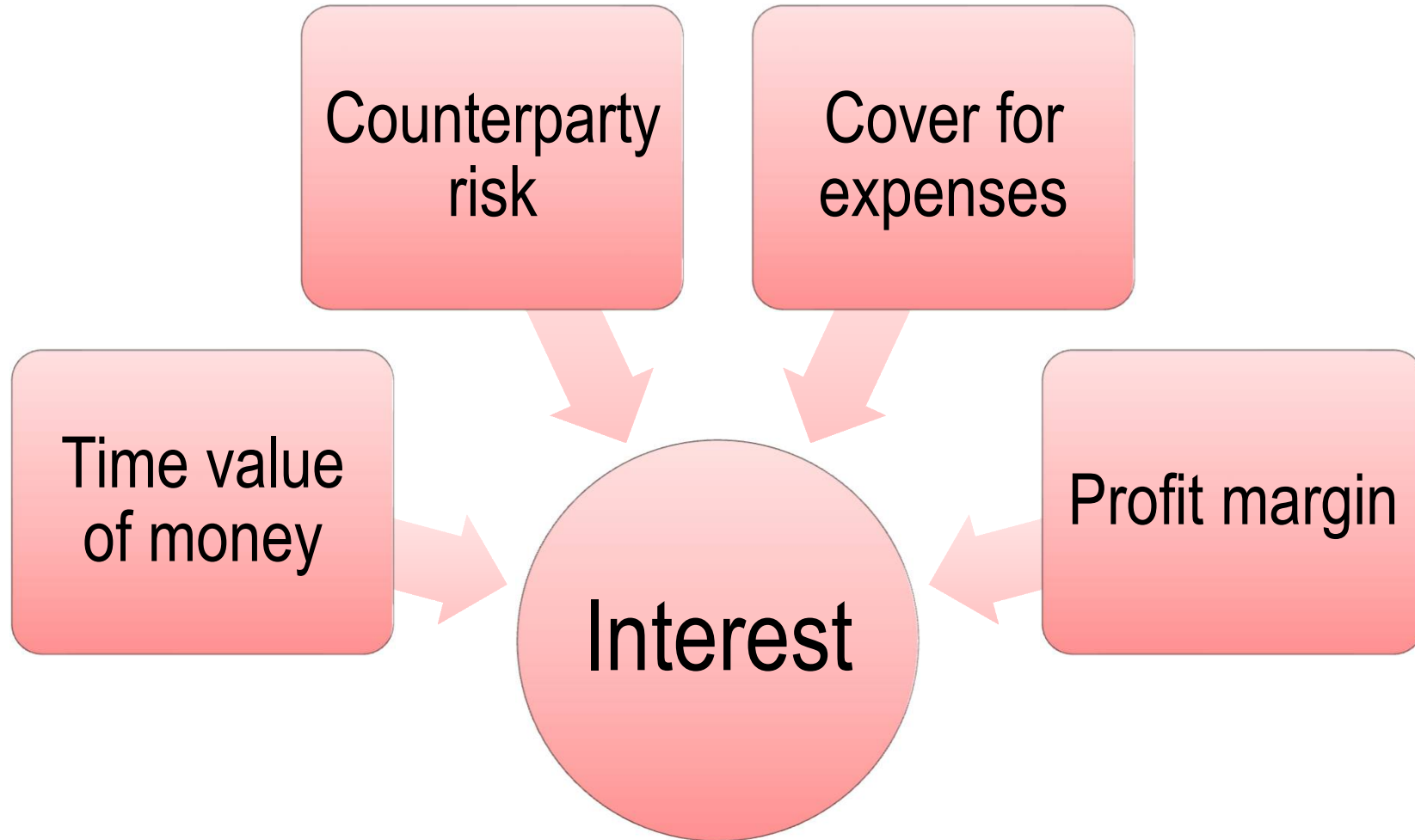
## Hold to collect



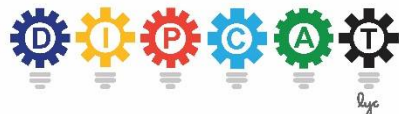
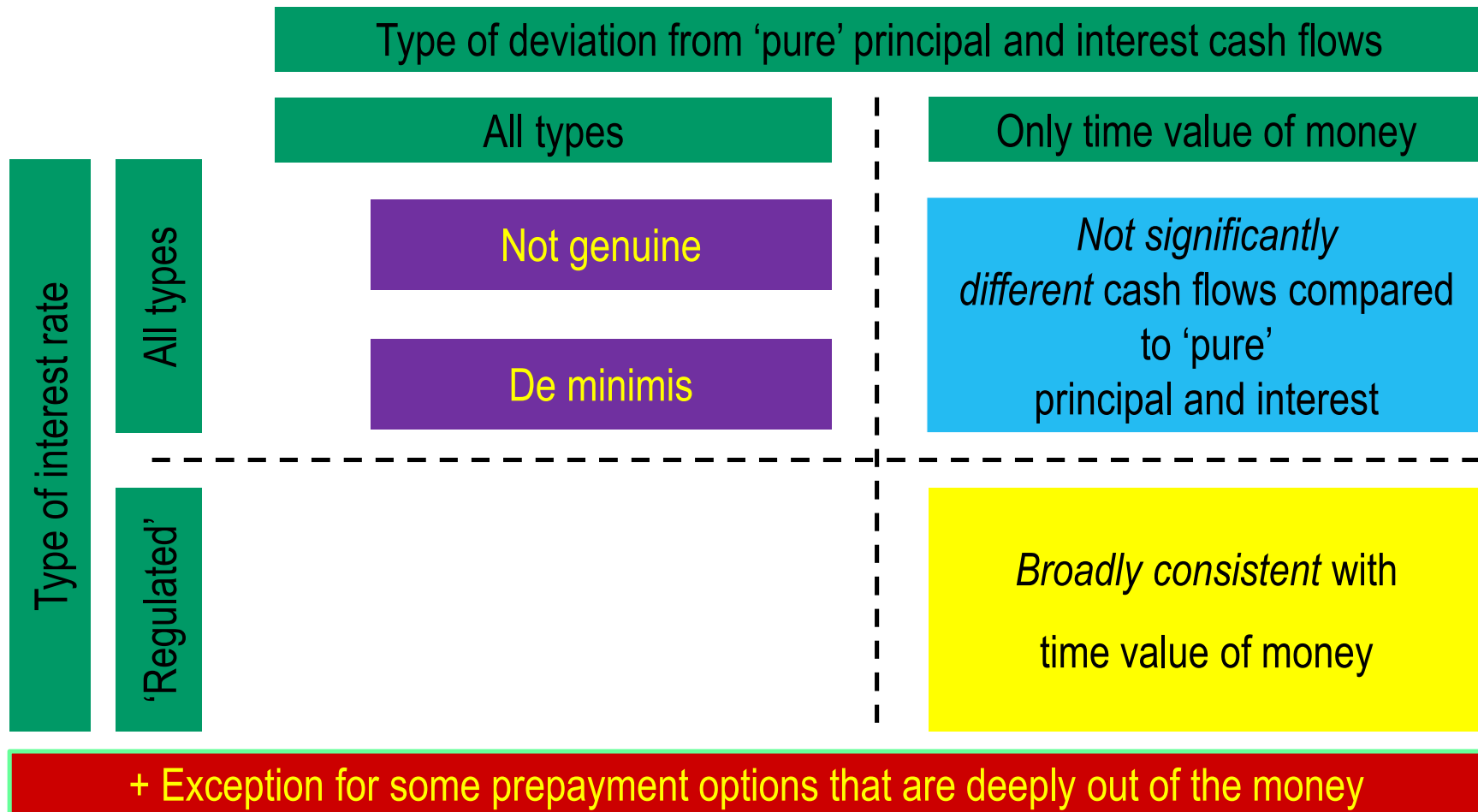
- ▶ Business model as determined by key management personnel
- ▶ Aim → hold assets to collect contractual cash flows
- ▶ Matter of fact and not an assertion → refer to actual management
- ▶ Evidence include
  - How is performance evaluated
  - How are risks managed
  - How are managers compensated
- ▶ Consider frequency, value, timing and reason and expectation about future → judgment
- ▶ Conditions that existed in the past as compared to current conditions
- ▶ Not the same as held to maturity, can meet the test if sales do occur or are expected to occur in course of
  - Increase in credit risk
  - Close to maturity and proceeds close to contractual cash flows
  - Infrequent and significant in value
  - Frequent and insignificant in value
- ▶ Assessment based on the reasonable expectations and not on worst or stress case scenarios



# SPPI test



# Contractual cash flow characteristics test 'solely principal and interest', unless:

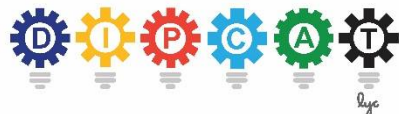
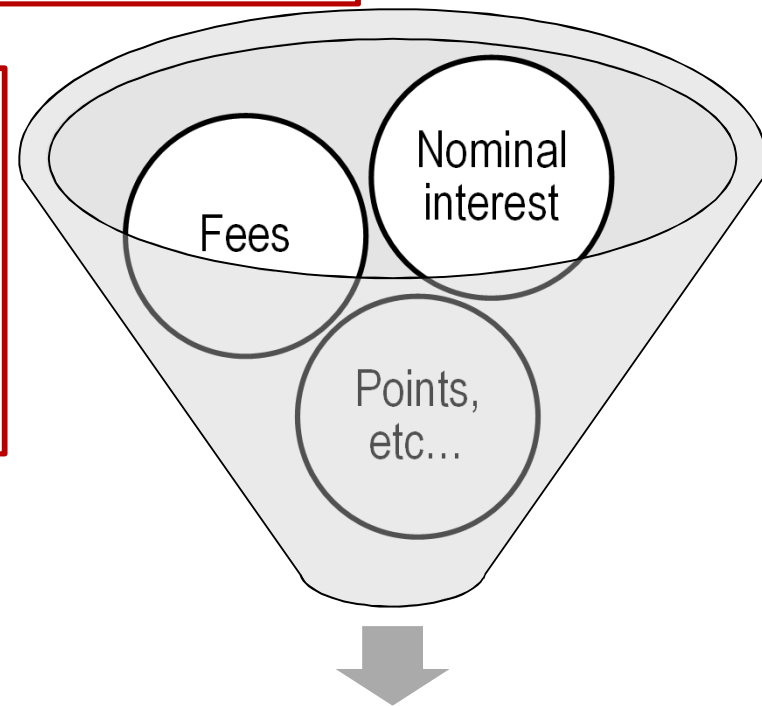


# Amortized cost

Amortised cost is the cost of an asset or liability adjusted to achieve **a constant effective interest rate** over the life of the asset or liability.

The effective interest rate is the discount rate that will give a **present value of future cash flows** that equals the purchase price.

The effective interest rate method determines how much interest income or expense will be reported in the income statement in each period.



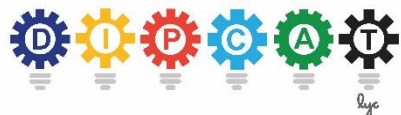
**Effective interest (IRR)**

**For example...**



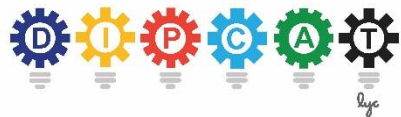
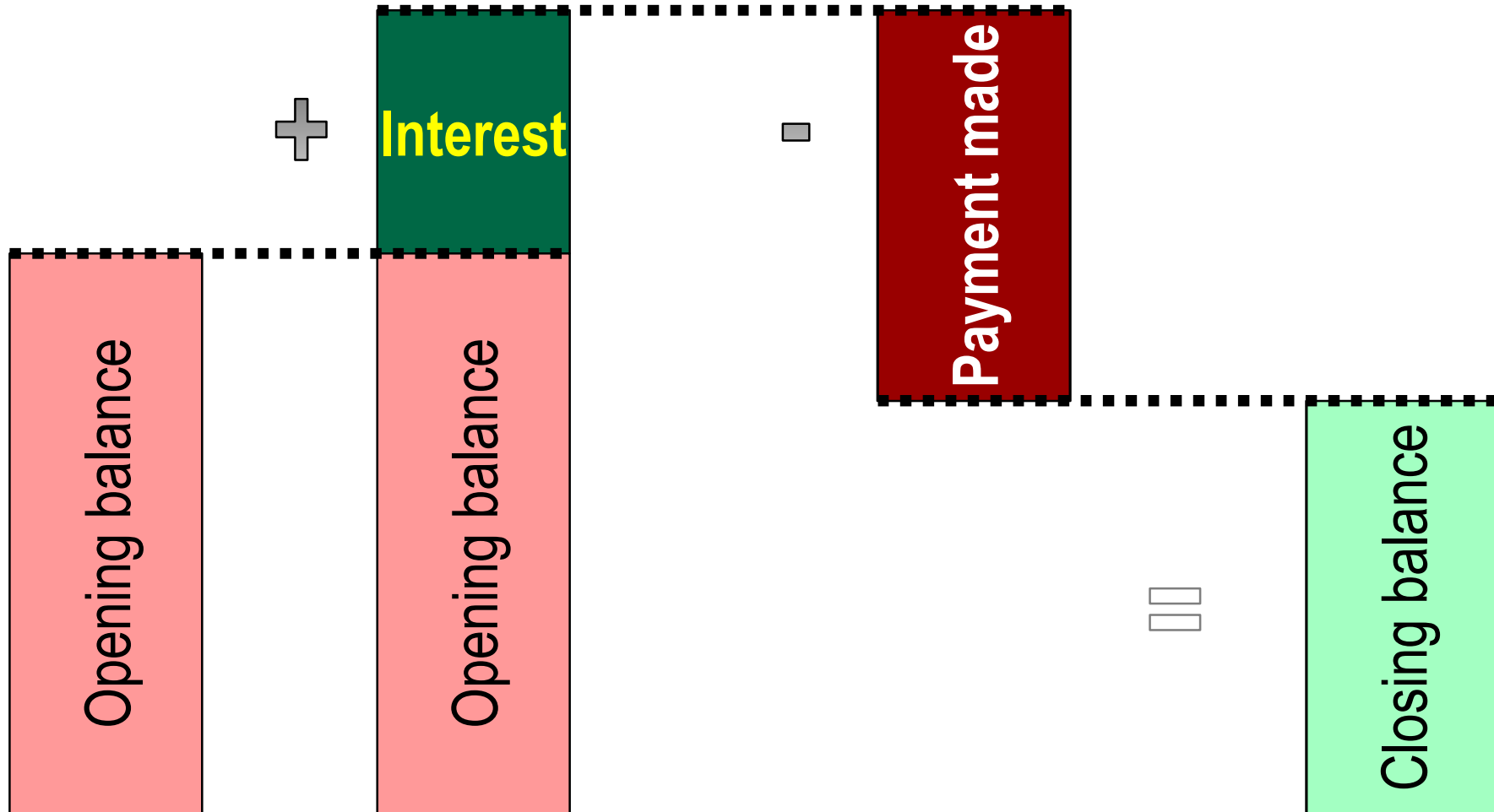
An entity originates a loan to a client on 1st January 20X1, that is 1 000 m€. The loan matures 5 years after the origination [31st December 20X5]. The loan's stated interest is 5% pa. The origination fee is 7% and the third year the entity collects 74 m€ monitoring fee from the client.

**How much is the amortized cost of the loan at the end of the 1st and 2nd year?**



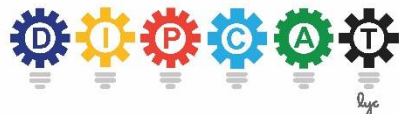


# Technical recap



# Calculation

Year	Opening balance	Interest	Cash flow	Closing balance
20X1				
20X2				
20X3				
20X4				
20X5				



# Calculation



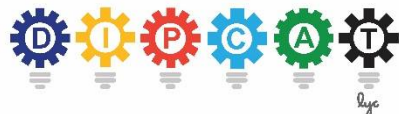
B/S

P/L

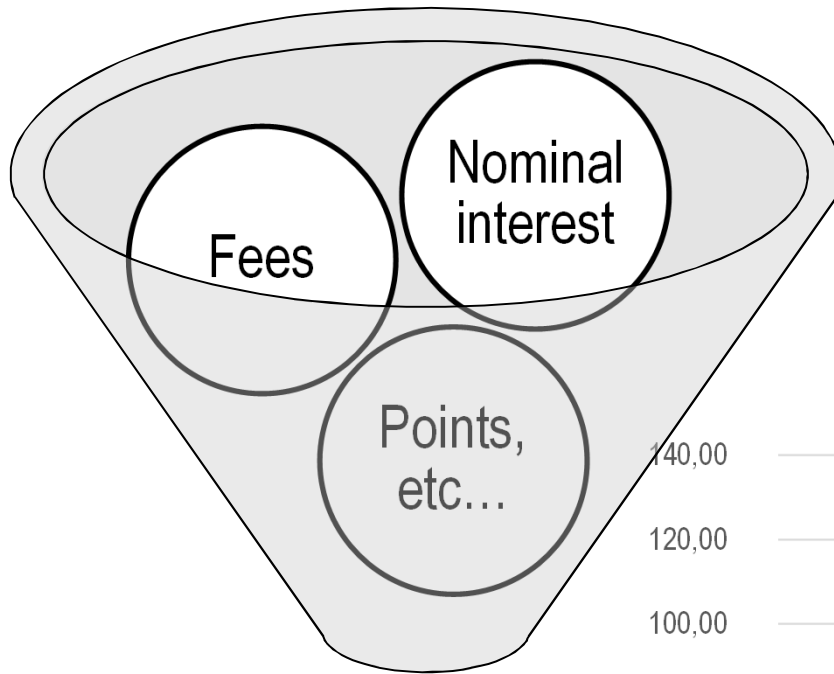
C/F

B/S

Year	Opening balance	Interest	Cash flow	Closing balance
20X1	930,00	76,58	(50,00)	956,58
20X2	956,58	78,77	(50,00)	985,36
20X3	985,36	81,14	(124,00)	942,50
20X4	942,50	77,61	(50,00)	970,11
20X5	970,11	79,89	(1 050,00)	0,00



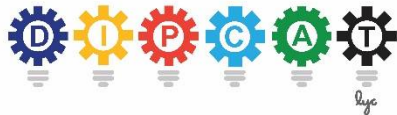
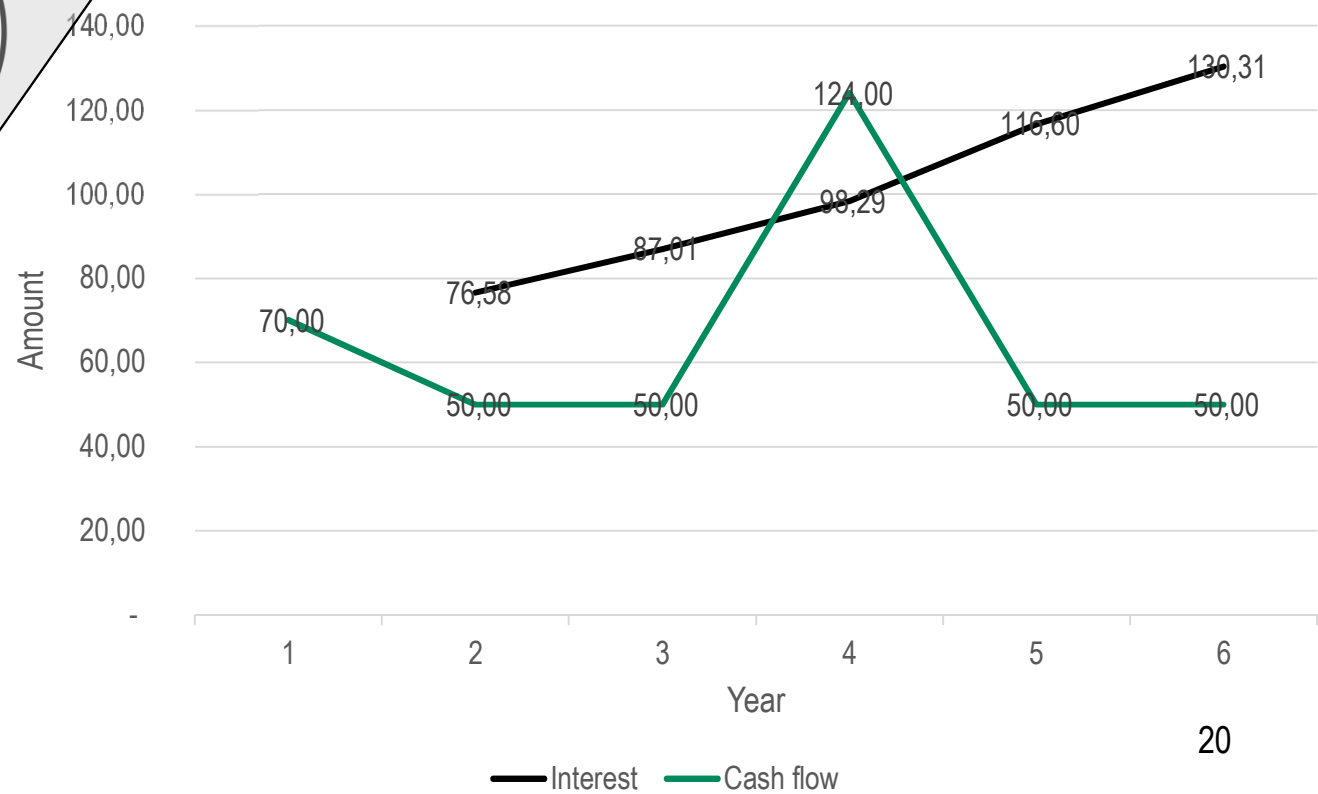
# What did we do?



How to split  
394k expense?

## What does effective interest do?

**Effective  
interest (IRR)**



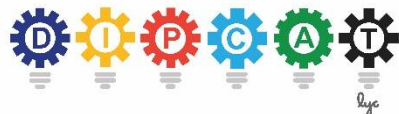
# How to deal with derivatives

A derivative is a financial instrument that has three characteristics

- Its value changes in response to changes in a specified variable.
- It requires a small or no initial investment.
- It is settled at a future date.

Examples:

- 1. Forward contracts
- 2. Forward rate agreements
- 3. Futures
- 4. Interest rate swaps
- 5. Call and put options



# Quick example

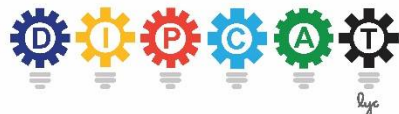


Being worried about foreign exchange risks, an entity entered into a foreign currency forward contract (FOREX) on 1 December 2019 in which 1 000 EUR will be converted into HUF. The settlement will be done on 31st January 2020. The contractually agreed rate for the FOREX contract is 320 HUF/EUR.

*The following spot or forward rates apply:*

Date	Spot	1 mth forward	2 mths forward
1 Dec 2019	311	317	320
31 Dec 2019	322	330	335
31 Jan 2020	325	326	323

**How this shall be reflected on 31st December 2019 in the financial statements?**



# Book keeping entries

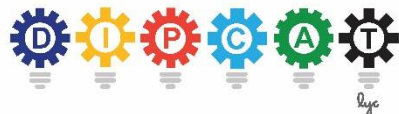
## 1/December/2019 – On entering to the deal

No entries required.

## 31/December/2019 – Year end valuation

$$(330 - 320) * 1\,000 = 10\,000$$

Dr. Derivative asset	10 000
Cr. Income statement	10 000



# Book keeping entries

## 31/December/2019 – Valuation

$$(323 - 330) * 1\,000 = - 7\,000$$

Dr. Income statement	7 000
Cr. Derivative asset	7 000

## 31/January/2020 – Settlement

Dr. Cash (euro) [323 * 1000]	323 000
Cr. Cash (HUF, per contract)	320 000
Cr. Derivative asset	3 000

