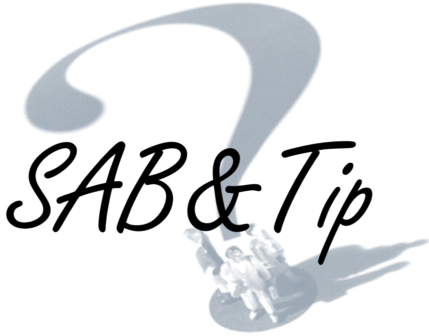


IFRS 9 Financial Instruments: Classification and measurement

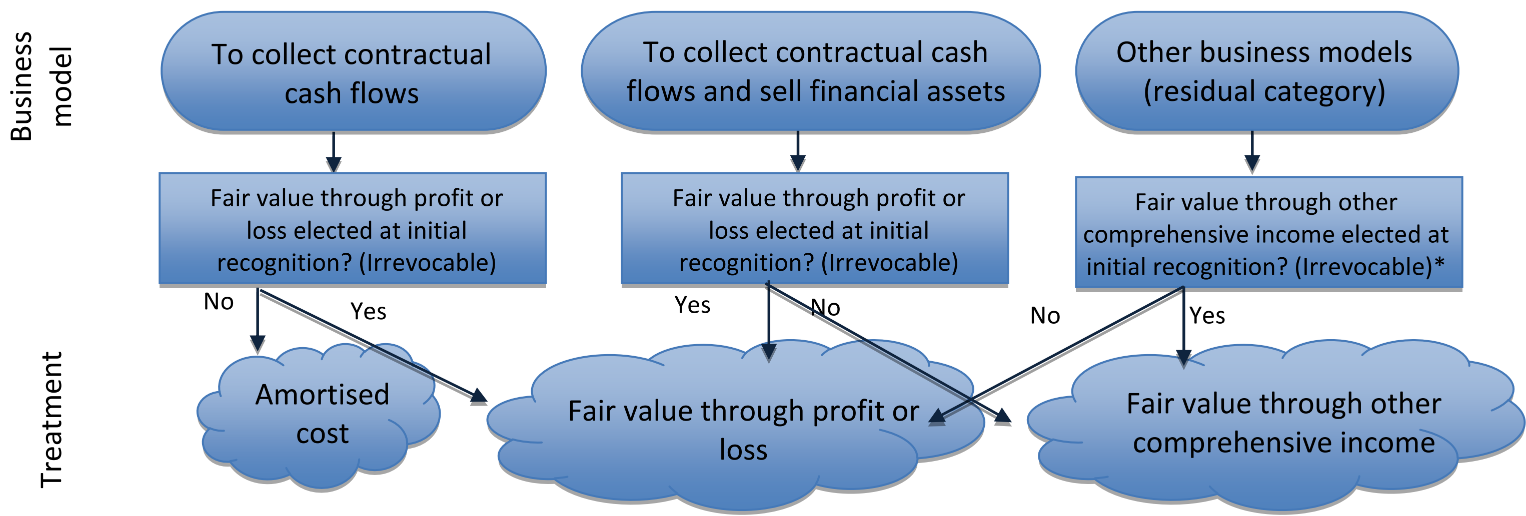
September 2015

Monthly Newsletter

The IASB's IFRS 9 Financial Instrument project aimed to replace IAS 39 was done in 3 phases: Classification and Measurement, Impairment, and Hedge Accounting. This month we focus on the first phase, classification and measurement.

Classification of financial assets

The classification of financial assets is determined based on how an entity manages its financial assets (its **business model)** and what the nature of the cash flows arising from the financial assets is (**contractual cash flow characteristics).**
An entity's business model is the manner in which an entity's financial assets are managed in order to generate cash flows. An entity may have more than one business model. The business model does not depend on management's intentions for an individual instrument. The following diagram illustrates the three business models for classification purposes of financial assets as well as the treatment of those financial assets:



** This election may only be made for equity instruments (such as an investment in shares) that are **not** held for trading. This classification is available on an instrument-by-instrument basis. All instruments that are held for trading must be classified as fair value through profit or loss.*

Classification of financial liabilities

All financial liabilities will be classified at amortised cost (default category), except for:

- Financial liabilities at fair value through profit or loss (designated as such or held for trading);
- Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies;
- Financial guarantee contracts; and
- Loan commitments to provide loans at below-market interest rates.

Financial liabilities at fair value through profit or loss are those liabilities that are held for trading. An entity may designate a financial liability at fair value through profit or loss if doing so results in more relevant information, because either it eliminates or significantly reduces an accounting mismatch, or a portfolio of financial liabilities is evaluated on a fair value basis. This designation is irrevocable and must be made on initial recognition.

Measurement of financial assets and financial liabilities

Initial measurement:

All financial instruments are initially measured at fair value as per the requirements in IFRS 13, *except trade receivables that do not have a significant financing component.*

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.

The fair value would normally be considered to be its **quoted price**, but a valuation technique such as discounted cash flow may be used if the market for the instruments is not active.

Transaction costs on all financial assets and liabilities are capitalised to the asset or liability, except for financial assets and financial liabilities that are carried at fair value through profit or loss, where they are accounted for as an expense.

Subsequent measurement

Financial assets and financial liabilities at amortised cost are subsequently carried at amortised cost using the effective interest rate method. This method exactly discounts estimated future cash receipts or payments to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.

Gains or losses arising from derecognition, reclassification, impairment or in the case of a financial asset, the amortisation process, will be recognised in profit or loss.

When the contractual cash flows of a financial asset are renegotiated or modified, the entity will recalculate the present value using the financial asset's original effective interest rate. The modification gain or loss is recognised in profit or loss.

All financial assets and financial liabilities at fair value through profit or loss are carried at fair value subsequent to initial recognition.

Fair value gains or losses (realised and unrealised) calculated on the subsequent measurement are recognised in profit or loss.

For financial liabilities that have been elected into the fair value through profit or loss category, the subsequent changes in fair value must be separated between those that result from changes in credit risk, and other changes. The changes that result in credit risk must be recognised in other comprehensive income and accumulated in equity. This separation is not required if the financial liability is a loan commitment or financial guarantee contract, or the separation would create or enlarge an accounting mismatch in profit or loss.

Financial assets at fair value through other comprehensive income are carried at fair value subsequent to initial recognition, and all fair value gains and losses are recognised in other comprehensive income. When the financial asset is derecognised, the cumulative fair value gain or loss in equity is recycled to profit or loss. However, those fair value gains or losses for financial assets *elected* into the fair value through other comprehensive income category is never recycled into profit or loss. The entity may transfer the cumulative gain or loss within equity.

Impairment losses, foreign exchange differences and dividends are recognised in *profit or loss*.

Derecognition

An entity shall derecognise a financial asset only when the contractual rights to the cash flows expire or it transfers the financial asset and that transfer qualifies for derecognition. *IFRS 9.B3.2.1 provides a flowchart to illustrate the evaluation of whether and to what extent a financial asset is derecognised.*

An entity shall derecognise a financial liability only when it is extinguished i.e. when the obligation specified in the contract is discharged or cancels or expires.

An exchange of debt instruments with substantially different terms between an existing borrower and lender of debt, or a substantial modification to the terms of an existing financial liability shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished or transferred and the amount paid will be recognised in profit or loss.