#DigInIFRS

By: Muzammil Hussain Korai

IFRS-9 (Part:1)
Classification and Initial Measurement of Financial Instruments

Measurement

Classification

Financial Asset

Debt Instrument (Such as bond, debenture, etc.)

Imagine:
You have invested in a company's 5 years' bonds, that will pay you interest each year and you can redeem your actual investment after 5 years. (i.e your contractual cashflows are: *Principal + Interest*)

Now, If :

- You aim to Hold those bonds till maturity (i.e for five years), and get contractual CFs only
  - Classify it under → **Amortized Cost**
- Aim to hold those bonds till maturity but you can sell them earlier (i.e before five years) if a favorable offer is received. (Get Contractual CFs as well as selling profit)
  - Classify it under → **Fair Value through OCI**
- That instrument cannot be classified under other two methods, or
- You irrevocably elect following method to avoid accounting mismatch
  - Classify it under → **Fair Value through Profit and Loss (P/L)**

Equity Instrument (Such as Shares)

- Default Classification → **Fair Value through Profit and Loss (P/L)**
- Entity may irrevocably elect → **Fair Value through OCI**

Financial Liability

By default Classified under → **Amortized Cost**

However

With a few exceptions, Such as if entity irrevocably elects to classify that liability at Fair Value through Profit and Loss (P/L), it can do so. Furthermore, there are also some other specific cases where an entity uses FVTPL method to recognize its liability.

Prepared by:
Muzammil Hussain Korai
(CA Finalist)

www.linkedin.com/in/muzammil-hussain-korai/

Initial Measurement

Financial Asset

If the ***Financial Asset*** is classified under either ***Amortized Cost*** or ***Fair Value Through OCI***

It will be recorded at Fair Value **Plus** Transaction Cost

	Dr.	Cr.
Financial Asset (FV+Transaction Cost)	XX	
Cash/Bank		XX
Gain/Loss (Balancing) P/L	XX /	XX

If the ***Financial Asset*** is classified under ***Fair Value Through Profit and Loss (P/L)***

It will be recorded at Fair Value **only**. (Transaction Cost will be expensed out)

	Dr.	Cr.
Financial Asset (FV)	XX	
Transaction Cost	XX	
Cash/Bank		XX
Gain/Loss (Balancing) P/L	XX /	XX

Financial Liability

If the ***Financial Liability*** is measured ***at Amortized Cost***

Will be recorded at Fair Value **Less** Transaction Cost

	Dr.	Cr.
Cash/Bank (Net)	XX	
Financial Liab. (FV – Trans. Cost)		XX
Gain/Loss (Balancing) P/L	XX /	XX

If the ***Financial Liability*** is measured at ***Fair Value Through Profit and Loss (P/L)***

Will be recorded at Fair Value **only**. (Transaction Cost will not be included in liab.)

	Dr.	Cr.
Cash/Bank (Net)	XX	
Transaction Cost	XX	
Financial Liab. (FV)		XX
Gain/Loss (Balancing) P/L	XX /	XX

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IFRS-9 (Part:2) ECL (Expected Credit Loss)/Impairment

Accounting for Expected Credit Loss (ECL)

Remember: ECL does not apply to debt instruments classified at fair value through P/L and the Equity Instruments.

Under: General Approach

At Initial Recognition

Record **12 months Expected Credit Loss (ECL)**

At each Subsequent reporting Date

Analyze whether Credit Risk on the Financial asset increased ***Significantly*** or not

- If Significantly: Amount equal to ***Life time Expected Credit Loss*** **(ECL)** will be recognized
- If not: Amount equal to ***Only 12 months Expected Credit Loss (ECL)*** will be recognized

Furthermore; If the asset on which ECL is going to be charged, is Classified under:

Amortized Cost

	Dr.	Cr.
Impairment Loss (P/L)	XX	
Allowance for ECL (**Contra Asset**)		XX

Fair Value through OCI

	Dr.	Cr.
Impairment Loss (P/L)	XX	
Allowance for ECL (**OCI**, **no contra asset**)		XX

Under: Simplified Approach

Applicable only to:

- Trade Receivables
- Lease receivables
- Contract assets

At Initial Recognition / **At each Subsequent reporting Date**

Amount equal to ***Life time Expected Credit Loss*** **(ECL)** will be recognized

Entry

	Dr.	Cr.
Impairment Loss (P/L)	XX	
Allowance for ECL (**Contra Asset**)		XX

Impairment Gain:

At each reporting date, the entity will reassess the impairment value. If, in later years, some favorable changes occur and the financial assets get strengthen resulting in impairment gain, entity will record that gain up to the maximum extent of earlier record loss allowance.

Prepared by: Muzammil Hussain Korai (CA Finalist)

Important Point

All of the above discussion applies when asset is either at stage 1 (No significant increase in credit risk since initial recognition), or stage 2 (Significant increase in credit risk since initial recognition, but not yet credit-impaired). However, if the asset reaches stage 3 (asset has actually become credit impaired), in that case things become a bit more complex. Such as interest income is recognized at net basis, instead of gross basis.

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IFRS-9 (Part:3)
Derecognition of Financial Asset

Decide whether to derecognize the asset or not?

Have the **rights** to the cash flows from the financial asset **expired?** — Yes → Derecognize the Asset

Such as Investing in a 5-years bond means we'll receive cash flows from it for only five years as agreed. After that, our right to those cash flows will expire.

No ↓

Has the entity **transferred** its **right** to receive the cash flows from the asset? — YES → Has the entity transferred substantially all the risk and rewards?

Such as, we purchased a plant. But instead of making a cash payment to the supplier, we transferred some bonds under our ownership to them

No ↓

Has the entity assumed an **obligation to pay** the cashflows from that financial asset to someone else? — No → Continue to recognize the asset

Such as, if we make investment on behalf of someone else. It means, all the cashflows coming from that asset will be transferred to that party in due time. It's our obligation to do so.

Yes ↓

Has the entity **transferred** substantially all the **risk and rewards?** — Yes → Derecognize the Asset

No ↓

Has the entity **retained control** of the asset? — No → Derecognize the Asset

Yes ↓

Continuing Involvement in The Asset

Such as if the entity transferred its trade receivables to a bank by entering into a **factoring agreement**. As per agreement, bank would be responsible for the risk of bad debts for up to 95% of the trade receivables. However, 5% risk will be borne by the entity. It means we have continuing involvement for those debtors. Hence entity will record a liability for those 5% trade receivables while debiting Transfer asset/continuing involvement in debtors. **Furthermore----**

As per **paragraph B3.2.13 (a) of IFRS-9**, we will record this continuing involvement at the lower of

- the carrying amount of the asset
- Max. amount that entity could be required to pay against the consideration received

Evaluating whether entity has transferred all the risks or not

Examples Where Risks and rewards are assumed **to be transferred**

- **Unconditional Sale** of a financial Asset
- A sale of a financial asset together with an option to **repurchase** the financial asset **at** its **fair value** at the time of repurchase

Examples Where Risks and rewards are **not transferred**

- A sale of short-term receivables in which **risk** of bad debt is **not transferred** to the other party
- A sale and repurchase transaction where the **repurchase** price is a **fixed price** or the sale price plus a lender's return;

On derecognition of a financial asset,

- the difference between: **(a)** the carrying amount (measured at the date of derecognition) and **(b)**the consideration received (including any new asset obtained less any new liability assumed), shall be recognized **in profit or loss.**
- Furthermore; **If** debt asset was measured at Fair value through **OCI**, the **cumulative gain or loss** previously recognized in OCI will now be reclassified **from equity to P/L** as a reclassification adjustment (IFRS-9.5.7.10)

Prepared by: Muzammil Hussain Korai (CA Finalist)

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IFRS-9 (Part:4)
Modification and derecognition of Financial Liability

Derecognition of Financial Liability

When

the obligation specified in the contract is discharged or cancelled or expires.

	Dr.	Cr.
Financial Liability	XXX	
Cash/Bank (if any)		XXX
Gain/loss (Balancing) **P/L**	XXX / XXX	

When

There's a significant modification in financial liability (equal to or more than 10% of its carrying value)

Modification in Financial Liability

Apply the following formula

To get the Change %age

Existing liability (Carrying amount)	**(A)**		XXX
Less:			
Present Value of liability under new terms ***(discounted using original/earlier effective interest rate.)***		XXX	
Transaction/Modification fee		XXX	
			(XXX)
Net Difference	**(B)**		XXX
Difference Percentage	**(B)/(A)** x 100%		XX%

Difference is ≥10%

- Derecognize the old liability.
- Recognize the new liability at its Fair Value. We can calculate that fair value by discounting the **new cashflows** at **market interest rate**.
- Any difference between the two will be charged to P/L

	Dr.	Cr.
Old Liability ***(carrying amount)***	XXX	
New Liability ***(at Fair Value)***		XXX
Gain/Loss (Balancing) **P/L**	XXX / XXX	

Difference is <10%

- Calculate NPV of **new cashflows** discounted at the **original Effective Interest rate**. Thid would be our revised liability now.
- Any difference between our revised liability and old liability will be charged to P/L

When new liab. is less than old one

	Dr.	Cr.
Financial Liability	XXX	
Modification gain (**P/L**)		XXX

When new lib. is More than old one

	Dr.	Cr.
Modification loss (**P/L**)	XXX	
Financial Liability		XXX

Treatment of costs incurred during modification

- If significant modification (≥10%), this cost will be charged to P/L
- If not significant modification (<10%), this cost will be adjusted with financial liability and amortized over the remaining term of the modified liability. This is done by adjusting Effective Interest rate

Prepared by:
Muzammil Hussain Korai
(CA Finalist)

www.linkedin.com/in/muzammil-hussain-korai/

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IFRS-9 (Part:5)
Hedge Accounting
(Fair Value & Cashflow Hedging)

*(**Note:** This flowchart is just for quick revision. Prior Knowledge is must to understand this properly.)*

Accounting for

Terms:

- **Hedging:** A strategy that is used to *reduce* the financial *risks* arising *from adverse movements* in fair value or cashflow of an asset, liability, or a future transaction.
- **Hedged item:** the asset, liability, or the future transaction whose risk of change in fair value or cashflow is being reduced
- **Hedging Instrument:** an instrument/ financial derivative (such as a forward/future contract) that is used to hedge risk on the hedged item.

Remember:
There's an inverse relationship between the gain/ loss over Hedging Instrument and the Hedged item. If there's a gain on one item, there will be the loss on the other one, and vice versa.

Fair Value Hedge

(At Reporting and Settlement Date)

1 Update the **hedging instrument as well as hedged item** to the fair value

2 Charge **Fair value gain/loss** of both items to **P/L** (unless it's equity instrument measured at FVTOCI)

Example where there's a G**ain on Hedging instrument** and **Loss on Hedged item** on reporting date

	Dr.	Cr.
Financial Asset from Hedging Instrument	XX	
Fair Value gain on hedging instrument **(P/L)**		XX

	Dr.	Cr.
FV Loss on hedging instrument **(P/L)**	XX	
Financial Liab. from Hedging Instrument		XX

Cashflow Hedge

(At Reporting and Settlement Date)

1 Calculate the **effective and ineffective portions** of the gain or loss on the **hedging instrument**;

2 Charge **effective portion** of the gain or loss on the hedging instrument **to OCI** and **ineffective portion to P/L**

Effective Portion:

Lower of:

- the cumulative gain or loss on the ***hedging instrument*** since the inception of the hedge, and
- the cumulative change in the fair value of the ***hedged item*** since the inception of the hedge

Example:
Company ABC has to purchase an equipment after three months. The Co. hedged the risk of increase in equipment's price by entering into a forward agreement. After 3 months, on Settlement Date, there was a ***Gain on Hedging Instrument*** of $500 and ***Loss on hedged item*** was $400. Now as per the rule, **Lower of the above two** is $400. Hence this is the ***effective portion*** and will be charged to OCI as "Cash flow hedge reserve".

	Dr.	Cr.
Financial Asset from Hedging Instrument	$500	
Cash flow hedge reserve **(OCI)**		$400
Ineffective portion of gain **(P/L)** ***(Balancing)***		$100

To keep things simple and short, I have assumed the same date to be the reporting as well as settlement date. However in reality, those two could be different, hence these values will be updated on each reporting date and settlement date

3 **Settlement of Forward Contract:**

	Dr.	Cr.
Cash	$500	
Financial Asset from Hedging Instrument		$500

4 **Actual Purchase of Machinery**

	Dr.	Cr.
Machinery	$28,000	
Cash		$28,000

5 **Adjustment of Cashflow Reserve:**

On settlement date, The accumulated amount available in "Cashflow Hedge Reserve (OCI)" will be adjusted with the carrying amount of the resultant asset or liability.

(In our example)

	Dr.	Cr.
Cash flow hedge reserve **(OCI)**	$400	
Machinery		$400

Please refer to IFRS 9 paragraph 6.5.11(d) for the adjustment of Cashflow Reserve in the case where there's no resultant asset or liability