# COURSE NOTES

# IFRS 9 Financial Instruments

## Lecture 3: Financial Assets & Impairment

### The SBR Exam Focus

We have started at the beginning in order to understand the complex accounting issue of financial instruments.

We have looked at accounting for debt and equity and now we are on lecture 3! It is all about financial assets!

Remember that something on financial instruments is expected to be tested in EVERY exam and can be tested in any part of the exam.

Your understanding of this topic could be tested in words, or numbers or more likely both!

Maybe there will be some accounting that you have seen before – but there will be certainly something new for everyone.

**There are four lectures.**

- The basics and debt & equity
- Recap & split equity accounting
- Financial assets & impairment
- Derivatives & hedging

**Structure of the lecture 3**

Recap
Financial assets
Impairment of financial assets (ECL)

## Financial Instruments - recap

How many financial instruments can you spot i.e. how many financial asset, financial liabilities or equity instruments?

| | $m | | $m |
|---|---|---|---|
| **Non-Current Assets** | | **Equity** | |
| Property Plant Equipment | X | Equity shares | X |
| Intangible Assets | X | Other Components of Equity | X |
| Investments | X | Retained Earnings | X |
| **Current Assets** | | **Non-Current Liabilities** | |
| Inventory | X | Debentures | X |
| Trade Receivables | X | Deferred tax | X |
| Cash | X | **Current Liabilities** | |
| | | Trade payables | X |
| | | Tax | X |
| **Total Assets** | **XX** | **Equity & Liabilities** | XX |

## Recap: Life cycle of liabilities

1. classification = default is Amortised Cost

(A/C or FVTPL if trading or Fair Value Option to avoid an accounting mismatch)

2. initial measurement

(A/C = FV less issue costs. FVTPL = FV)

3. subsequent measurement

(A/C = A/C. FVTPL = FVTPL or OCI if due to changes in own credit risk)

4. De-recognition

(Extinguished, discharged, cancelled, expired)

## Recap example: amortised cost financial liability

Quade issues a 3-year $20,000 5% bond issued at par.
The effective rate is 10%
The bond will be redeemed at a premium.

***Q Show the accounting for Year 1***

**Your Answer**
Initial recognition

Year 1 Finance cost increases the liability.

Year 1 Cash paid decreases the liability.

Year 1 Closing liability

## "Recap" example: amortised cost financial asset

Cooper subscribes to a
3-year $20,000 5% bond issued at par.
The effective rate is 10%
The bond will be redeemed at a premium.

***Q Show the accounting for Year 1***

**Your Answer**
Initial recognition

Year 1 Investment income increases the asset.

Year 1 Cash received decreases the asset.

Year 1 Closing Asset

## Financial Assets: examples

Examples of financial assets include trade receivables (debtors), loans (if a lender) and investments in both shares (equities) and in bonds (debt).

Whilst these are names that are familiar to us and are used on the statement of financial position – for IFRS purposes they have to be classified into one of three camps. The name of the classification will ultimately determine the accounting treatment.

## 1: Classification of financial assets

Financial assets have to be classified as either being:

- Amortised cost, or
- FVTOCI, or
- FVTPL

**SPPI**

First it is necessary to consider the cash flow test.

This is met if the cash flows are contractual and arise on specified dates and represent solely the payment of principal and interest on the amount outstanding.

The cash flow test is “SPPI”.

| IF the SPPI cash flow test is met | IF the SPPI cash flow test is NOT met |
|---|---|
| Financial asset is a debt instrument.<br><br>Holder is a lender and is owed cash.<br><br>Now consider the **business model** to determine the accounting treatment.<br><br>1. Keep for forever = Amortised cost<br>2. May sell = FVTOCI<br>3. Other = FVTPL | Financial asset is an equity instrument.<br><br>Holder is an investor and owns a share of the business.<br><br>Investment must be a fair value.<br><br>Default accounting treatment = FVTPL<br><br>However, can be = FVTOCI (if at initial recognition an irrevocable designation) |

## Q Webb

Webb purchased some financial instruments for consideration of $500m.

The investment has a historic track record of making regular, but variable, returns but these are neither contractual nor guaranteed.

Webb has no intentions in the short term of selling the investment.

During the year Webb received $10 million as a return on its investment. At the reporting date the fair value of the investment was $540 million.

***Q How should Webb classify this financial asset?***
***3 marks***

## Q Ellis

Ellis purchased some financial instruments for a consideration of $200 million.
The investments are corporate bonds which pay a small, fixed return on a quarterly basis. On the redemption date in ten years a premium will be paid.

Ellis has no intention of selling the investment and will keep the investment to maturity.

During the year Ellis has received the contractual cash flows. At the reporting date it has been correctly determined that the carrying value applying amortised cost is $210 million and the fair value of the investment is $216 million.

***Q How should Ellis classify this financial asset?***
***3 marks***

## 2: Initial measurement of financial assets

The initial measurement of financial assets will depend on their initial classification. The starting point is that all are measured at fair value. However, if there are transactions costs these are capitalised if the financial asset is amortised cost or FVTOCI.

**Amortised cost**
Fair value plus transaction costs

**FVTPL**
Fair value (with transaction costs expensed to profit)

**FVTOCI**
Fair value plus transaction costs

## 3: Subsequent measurements of financial assets

| | | |
|---|---|---|
| Classification | | Accounting treatment |
| Amortised cost | | |
| FVTOCI | | |
| FVTPL | | |
| | | |

Hopefully no surprises here!

## Q Kinks V1

Kinks has a financial year-end of 31 December. On 1 January 20X1, Kinks bought a $100,000 5% bond for $95,000 incurring transaction costs of $2,000. Interest is received in arrears. The bond is due to be redeemed on 31 December 20X3 at a premium of $5,960. The effective rate of interest of the asset is 8%.
Kinks will hold this asset until maturity.

**Q What's the accounting?**
Does this meet the cash flow test (SPPI)

What is the business model?

What is the initial recognition?

Yr 1 PL Investment income?

Yr 1 Year-end balance?

**Q Kinks V1**

| | Opening balance | Profit and loss | Cash flow | Year-end balance |
|---|---|---|---|---|
| Yr 1 | | | | |
| Yr 2 | | | | |
| Yr 3 | | | | |

## Q Kinks V2

Kinks has a financial year-end of 31 December. On 1 January 20X1, Kinks bought a $100,000 5% bond for $95,000 incurring transaction costs of $2,000. Interest is received in arrears. The bond is due to be redeemed on 31 December 20X3 at a premium of $5,960. The effective rate of interest of the asset is 8%.
Kinks may hold this asset until maturity but may sell.
The fair value of the bond was $110,000 on 31 December 20X1 and $104,000 on 31 December 20X2.

**Q What's the accounting?**
Does this meet the cash flow test (SPPI)

What is the business model?

What is the initial recognition?

Yr 1 PL Investment income?

Yr 1 Year-end balance?

Yr 1 What is the gain or loss in OCI?

**Q Kinks V2**

| | O /bal | P&L | Cash flow | Carrying value | Gain or loss in OCI (to bal) | Year-end value |
|---|---|---|---|---|---|---|
| Yr 1 | | | | | | |
| Yr 2 | | | | | | |
| Yr 3 | | | | | | |

Note that the annual PL income figure is not based on the FV, rather than the amortised cost opening balance so refer back to V1.

The annual PL income (return on the investment) is not going to change as a result of the decision to remeasure the financial asset at fair value.

## Q Kinks V3

Kinks has a financial year-end of 31 December. On 1 January 20X1, Kinks bought a $100,000 5% bond for $95,000 incurring transaction costs of $2,000. Interest is received in arrears. The bond is due to be redeemed on 31 December 20X3 at a premium. The effective rate of interest of the asset is 8%.

Kinks will trade the bond before maturity and sold the asset in early 20X2 for $111,000. The fair value of the bond was $110,000 on 31 December 20X1.

**Q What's the accounting?**
Does this meet the cash flow test (SPPI)

What is the business model?

What is the initial recognition?

Yr1 PL Investment income?

Yr1 Year-end balance?

Yr1 What is the further gain or loss in PL?

## Financial assets – reclassification

Having classified a financial asset as either amortised cost, or FVTPL, or FVTOCI, to reclassify it is rare.

Reclassification is only allowed if there has been a change in the business model.

Reclassification is done on a prospective basis so that the previously recognised gains and losses are not restated.

**Consider**
A traditional mortgage lender has a portfolio of debt instruments correctly accounted for at amortised cost because the business model is to hold and collect.
It has now decided to cease to write new business (make new loans) and is now looking to sell these financial assets.
In these circumstances the business model has changed. Changes in fair value are now relevant to users. In these rare circumstances the debt instruments are reclassified from amortised cost to FVTP&L. There is no need to change the past – after all amortised cost was correctly applied when there was never any intention to sell, and the lender was going to wait patiently to collect the cash. Accordingly, it makes sense that changes in fair value are accounted for on a prospective basis (not retrospective), because now the intention is to sell the asset.

## 4. De-recognition of financial assets

Financial assets will be removed from the statement of financial position when:

- it has been sold and the transfer qualifies for de-recognition because **substantially all the risks and rewards of ownership have been transferred** from the seller to the buyer, or

- the contractual rights to the cash flows of the financial asset have expired, e.g. when an option held by the entity has expired and become worthless

## Q Skinner

Skinner is factoring trade receivables. It is legally selling (assigning) the trade receivables for an amount of cash less than the nominal amount.

The debtors are $100,000 and the factor (the bank) has paid only $90,000.
Skinner will receive the cash $90,000 (Dr Cash) but is unsure how to complete the accounting.

***Q Discuss the accounting (alternatives)***
***5 marks***

## Q McCaw

McCaw holds 10,000 shares in Hill with a carrying value of $30,000. McCaw sells this investment to Pocock for the fair value $40,000. McCaw has recognised a profit of $10,000 on the transaction.

Under the sale contract Pocock is required to transfer the shares in Hill back to McCaw in one year for $44,000 and pay over any dividends to McCaw.

***Q Discuss McCaw's accounting***
***4 marks***

## Q O'Driscoll

O'Driscoll provides staff with soft loans as an employee benefit.

At the start of the accounting period a total of $400,000 was paid out in a series of interest free loans, repayable two years later.
Current interest rates are 10%

***Q Explain how O'Driscoll should account for this loan***
***5 marks***

| **Initial recognition** | $ | | $ |
|---|---|---|---|
| **Dr** | | | |
| **Dr** | | | |
| **Cr Cash** | | | 400,000 |

| **Financial asset subsequent accounting** | | | |
|---|---|---|---|
| Opening balance | PL Income | Cash received | Closing balance |
| $ | $ | $ | $ |
| | | | |
| | | | |

| | | | |
|---|---|---|---|
| **Y1 PL** | | | $ |
| **Administration expense** | | | |
| **Investment income** | | | |
| | | | |
| **Yr1 S of FP** | | | |
| **Current asset Financial** | | | |
| **Current asset Other (pp exp)** | | | |

Cup of tea!

## Impairment of financial assets: overview

Because every loan and receivable has at least some probability of defaulting in the future, every loan or receivable has an expected credit loss (ECL) associated with it—from the moment of its origination or acquisition.

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

As the phrase ECL starts with the word “expected” and so implies the impairment model used for financial assets is a forward-looking model i.e. there does not have to be a past event before an impairment loss is recognised.

Because the expected credit loss model anticipates future bad news it is both a very prudent and subjective model.

Basically, when we are considering the impairment of financial assets, we are making an allowance for bad debts – or to use old fashioned language, making a provision for bad debts.

Impairment losses on financial assets are always recognised in the profit and loss account – as would any reversals.

## Impairment of financial assets: definition

The shorthand for the definition of ECL is the expected cash shortfall.

Credit losses are the difference between the contractual cash flows and the cash flows that the entity expects to receive, discounted at the original effective interest rate.

ECL is the weighted average of credit losses with the respective risks of a default occurring as the weights.

## Impairment of financial assets: scope

The types of financial assets where ECL and impairment losses are recognised are

- Financial assets measured at amortised cost
- Financial assets mandatorily measured at FVTOCI (Debt)
- Lease receivables
- Trade receivables

So, equity investments are not subject to ECL.

## Impairment of financial assets: approach

**Initial recognition (stage 1)**
When the financial asset is originated or purchased, a 12-month ECL should be recognised. This could well be nil if there is no expected default.

Any loss allowance (impairment) is accounted for separately and only netted off in the statement of financial position for presentational purposes.

In this way any interest income is calculated on the gross carrying amount (i.e. without deduction for ECLs)

**Annual review (stage 2)**
Each year the credit risk needs to be reviewed. If it has not increased, then continue with a 12-month ECL.

If the credit risk is judged to have increased, then it is necessary to recognise ECL on a lifetime basis.

The extra allowance is charged to the profit or loss account.

Any interest income is calculated on the gross carrying amount (i.e., without deduction for ECLs)

**Objective evidence of impairment exists at the reporting date (stage 3)**
If there has been objective evidence of actual impairment e.g. then recognise ECL on a lifetime basis AND any interest income is based on the net carrying value (so will be less).

## Q Robinson

Robinson has just paid $900,000 for financial assets with an effective rate of 5%
They are correctly classified and accounted for at amortised cost. There is a low risk of default.

On initial recognition there is an expectation that the cash shortfall will be $1,000 per annum. At the first reporting date this estimate has been revised to $1,500.

***Q Explain & calculate ECL***

**Robinson Answer plan**

**Stage 1**

**Stage 2**

## Q Carling

Carling has $100,000 financial assets (debt instruments) that have two years to maturity and are correctly accounted for at amortised cost. These assets have a coupon rate of 10% as well as an effective rate of 10%.

No previous loss allowance has been recognised as the 12-month ECL was assessed to be nil.

At the year-end information has emerged that the sector in which the borrowers operate is experiencing tough economic conditions. It is now felt that a proportion of loans will default over the remaining loan period and therefore the credit risk has increased significantly. After considering a range of possible outcomes, the overall rate of return from the portfolio is expected to be only 4% per annum for each of the next two years.

The debt instruments are not credit impaired.

***Q Calculate the lifetime ECL.***

**Carling Answer plan**
What are the contractual cash flows?

What are the expected cash flows?

What's the difference?

| | Short fall | DF | PV FCF |
|---|---|---|---|
| Yr 1 | | | |
| Yr 2 | | | |
| Lifetime ECL | | | |

## Q Lawes

Lawes made a long-term loan of $10 million to a key supplier. This was correctly classified and accounted for at amortised cost. On initial recognition no expected credit losses were recognised.

Under the terms of the loan the supplier agreed to make annual interest payments of $500,000 each year. These were always made. Two years prior to redemption the carrying value of the financial asset was $10 million but the supplier was now facing financial problems.

The supplier was certain not to be able to meet either of the last two interest payments. It was only judged 80% likely that the principal would be repaid.
The loan documentation states that the effective annual rate of interest implicit in the loan is 5%.

***Q Calculate ECL***

**Lawes Answer plan**

What are the contractual cash flows?

What are the expected cash flows?

What's the difference?

| | Short fall | DF | PV FCF |
|---|---|---|---|
| Yr 1 | | | |
| Yr 2 | | | |
| Lifetime ECL | | | |

## Impairment of financial assets: credit impaired financial assets

The rules are different for purchased or originated credit-impaired financial assets because they are already credit impaired at initial recognition.

For these assets, an entity would recognise a lifetime of ECL at initial recognition and each year the change in lifetime expected credit losses in the profit or loss.

A financial asset is credit-impaired when one or more events that have occurred and have a significant impact on the expected future cash flows of the financial asset.

It includes observable data such as:

- significant financial difficulty of the issuer or borrower;
- a breach of contract, such as a default or past-due event;
- the lenders for economic or contractual reasons relating to the borrower's financial difficulty granted the borrower a concession that would not otherwise be considered;
- becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for the financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects incurred credit losses.

## Impairment of financial assets: Simplified approach

On initial recognition of trade receivables - no ECL.

Any loss allowance will be the present value of the expected cash flow shortfalls over the remaining life of the receivables.

This approach uses the conventional matrix method (aged receivables list) of considering historically observed default rates and adjusted for forward-looking estimates.

## One last thing

Sexton decides to purchase some of its own shares for $20,000.

**Discuss?**
**Can Sexton's investment in its own shares be recognised as an asset?**

# The Key Takeaways

## Life Cycle of Financial Assets

**1. Classification**
Consider the cash flow test of the payments being solely payments of principal and interest (SPPI)
Not SPPI = Equity and must be at FV
Default for equity FVTPL (FVTOCI if irrevocable election)
Yes SPPI = Debt and consider business model
Hold forever = A/C
Hold maybe sell = FVTOCI
Other = FVTPL
**2. Initial measurement**
A/C = FV + transaction costs
FVTPL = FV,
FVTOCI = FV + transaction costs
**3. Subsequent measurement**
A/C = A/C
FVPTL = FVTPL,
FVTOCI = FVTOCI
**4. De-recognition**
Risks & rewards

## Impairment of Financial Assets

Credit losses are the difference between the contractual cash flows and the cash flows that the entity expects to receive, discounted at the original effective interest rate.

Expected credit losses are the weighted average of credit losses with the respective risks of a default occurring as the weights.

Initial recognition 12 months ECL
Lifetime ECL if risk of default

## WHAT'S NEXT?

- Quizzes
- Homework – – please do the questions of White, Fang & Rowe and then review the answers!

### Next Topic

- Derivatives and hedging