SLFRS 09 – Financial Instruments.

1.0 Introduction

SLFRS 09 specifies how an entity should classify and measure financial assets, financial liabilities, and some contracts to buy or sell non-financial items.

In the initial recognition an entity measures a Financial Asset or Financial liability at its Fair value plus or minus Transaction cost that are directly attributable to the acquisition or issue of the Financial Asset or Financial liability except for Financial Asset or Financial liability which is measured at Fair value through profit or loss. In such case transaction cost to be charged to the profit or loss as expense or Income.

There are some principle differences between LKAS 39 and SLFRS 09 as follows.

LKAS 39	SLFRS 09
• **Rule-based**	• **Principle-based**
• **Complex and difficult to apply**	• **Classification based on business model and nature of cash flows (Cash flow model – SPPI Test - S**olely **P**ayments of **P**rincipal and **I**nterest)
• **Multiple impairment models**	• **One impairment model**
• **Own credit gains and losses recognized** • **In profit or loss for fair value option (FVO)** • **Liabilities**	• **Own credit gains and losses presented in** • **OCI for FVO liabilities**
• **Complicated reclassification rules**	• **Business model-driven reclassification**

2.0 Business model

A business model refers to how an entity manages its financial assets in order to generate cash flows—by collecting contractual cash flows, selling financial assets or both. The business model should be determined on a level that reflects how financial assets are managed to achieve a particular business objective. However, the determination is not dependent on management's intentions for an individual instrument, and should be made on a higher level of aggregation.

What business model qualifies for amortised cost?

Financial assets at amortised cost are held in a business model whose objective is to hold assets in order to collect contractual cash flows.

What business model qualifies for fair value through other comprehensive income (FVOCI)?

Financial assets classified and measured at fair value through other comprehensive income are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

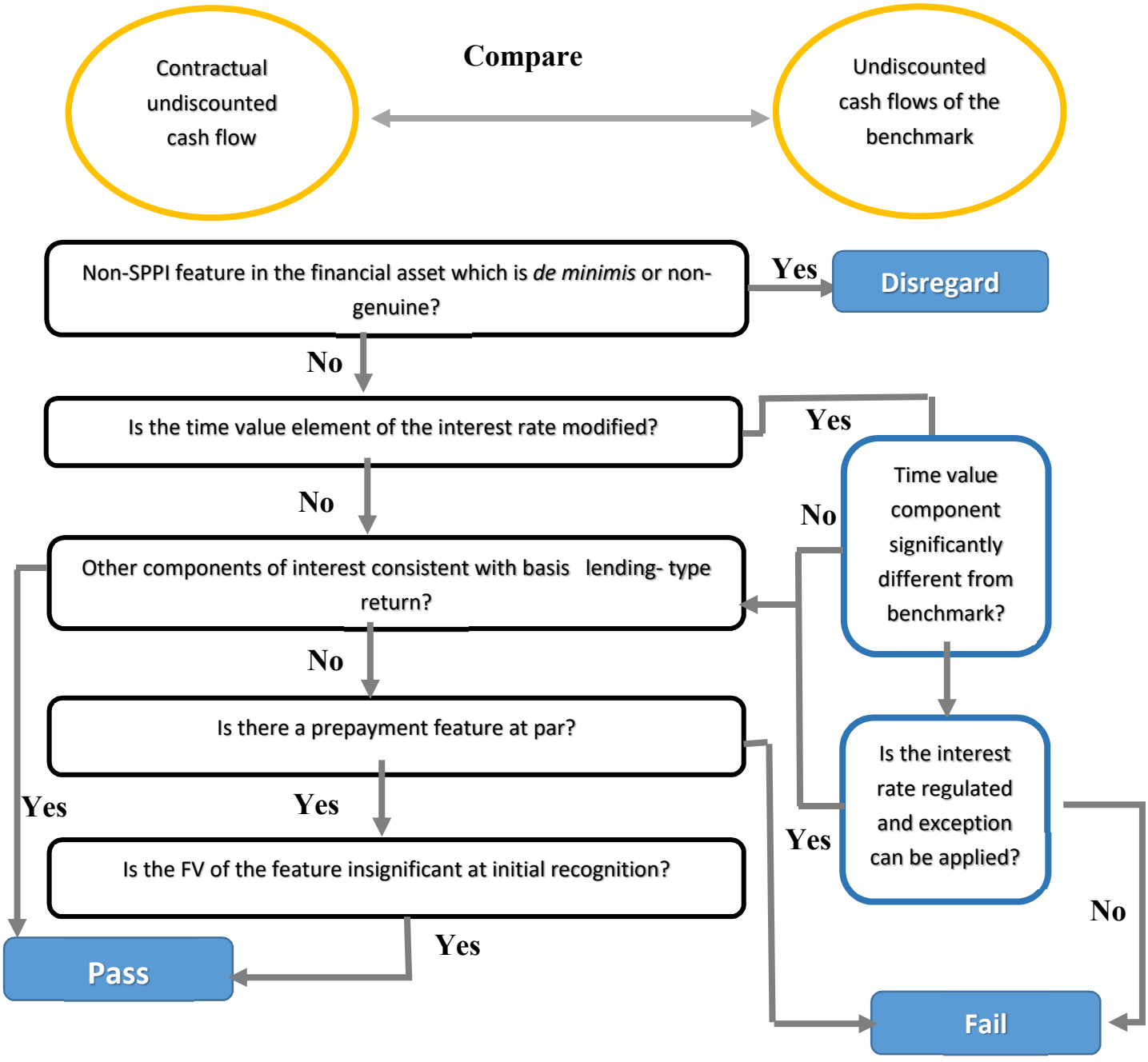
Other business models

Any financial assets that are not held in one of the two business models mentioned above are measured at fair value through profit or loss. As such, fair value through profit or loss represents a 'residual' category. Financial assets that are held for trading and those managed on a fair value basis are also included in this category.

3.0 Cash flow characteristics test

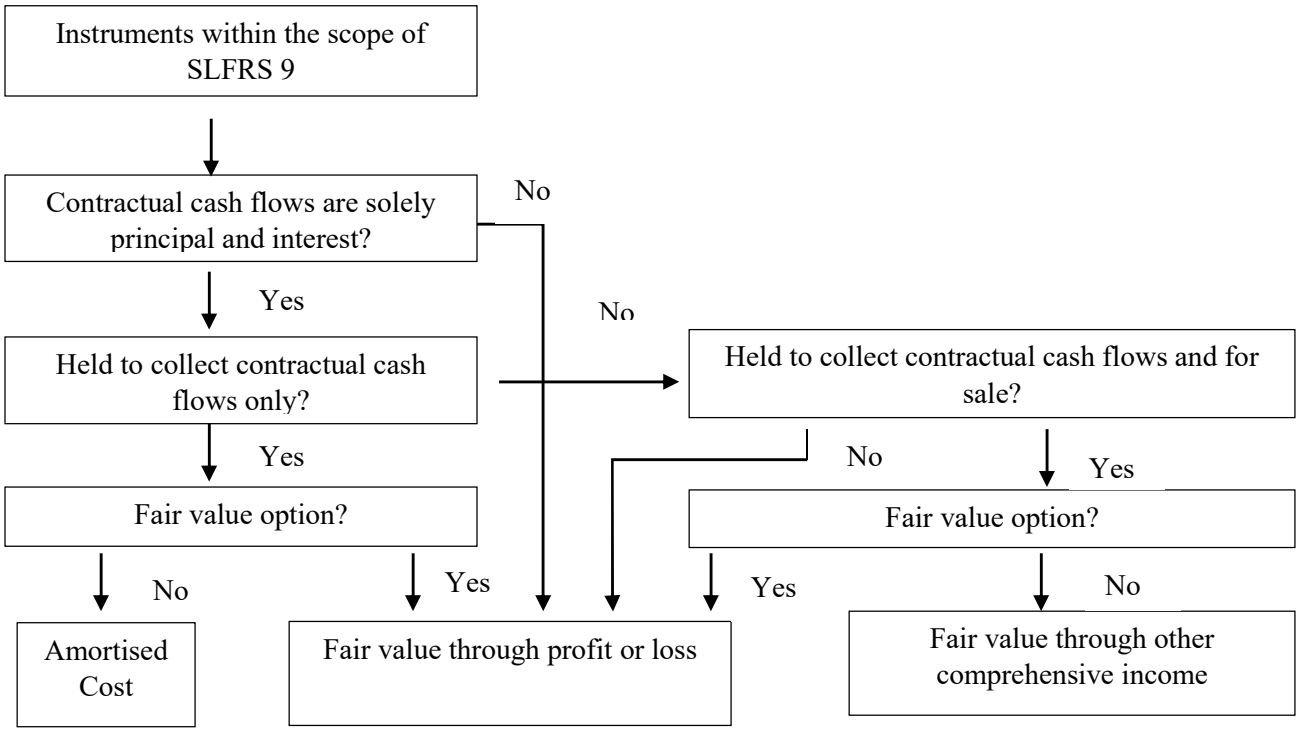
The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Assessing the cash flow characteristics also includes an analysis of changes in the timing or in the amount of payments. It is necessary to assess whether the cash flows before and after the change represent only repayments of the nominal amount and an interest rate based on them.



4.0 Classification of Financial Assets

Process for determining the classification and measurement of financial assets



Financial assets

When an entity first recognises a financial asset, it classifies it based on the entity's business model for managing the asset and the asset's contractual cash flow characteristics, as follows:

- Amortized cost—a financial asset is measured at amortized cost if both of the following conditions are met:
  - the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
  - the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
- Fair value through other comprehensive income—financial assets are classified and measured at fair value through other comprehensive income if they are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.
- Fair value through profit or loss—any financial assets that are not held in one of the two business models mentioned are measured at fair value through profit or loss.

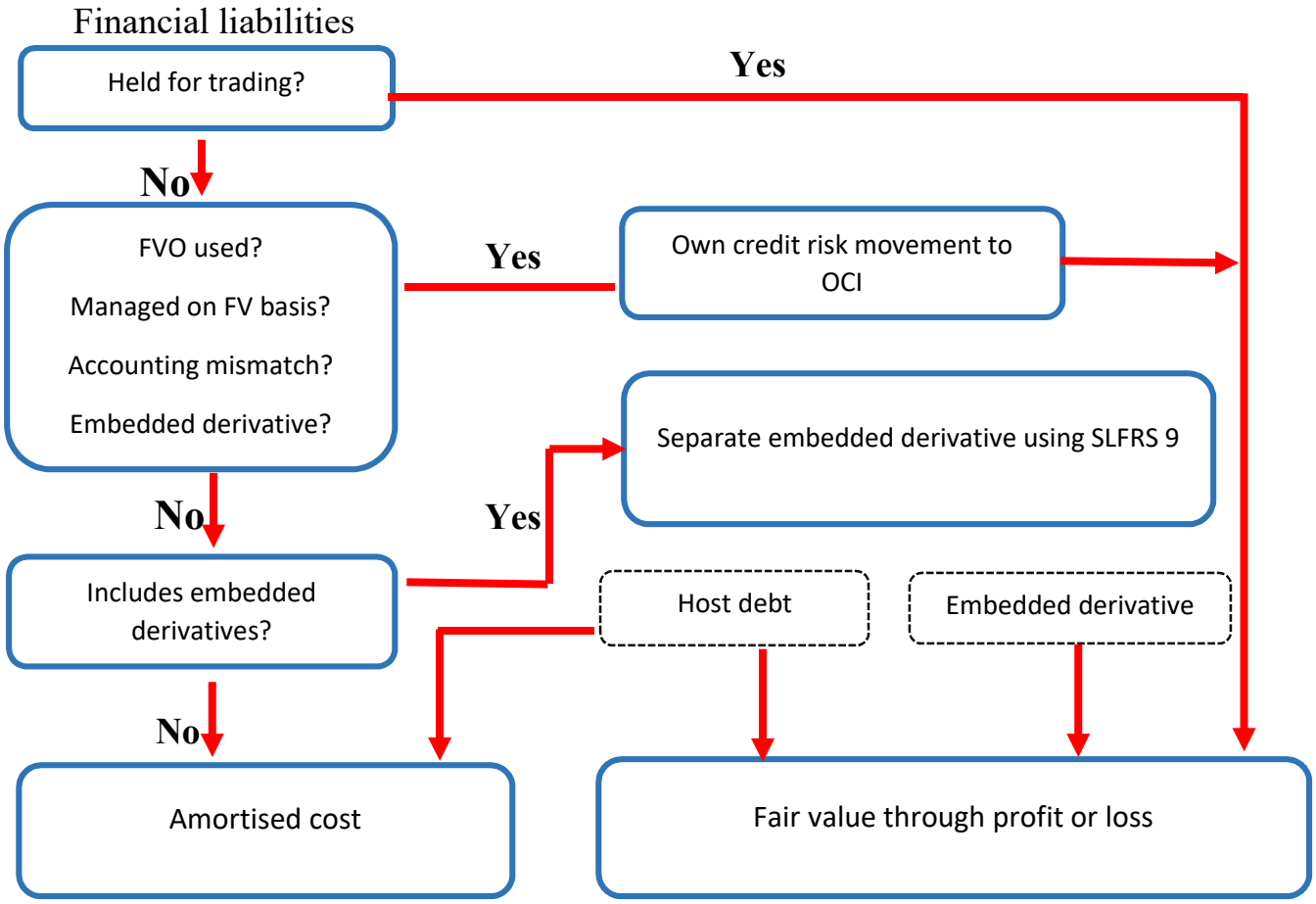
When, and only when, an entity changes its business model for managing financial assets it must reclassify all affected financial assets.

5.0 Financial liabilities

All financial liabilities are measured at amortised cost, except for financial liabilities at fair value through profit or loss. Such liabilities include derivatives (other than derivatives that are financial guarantee contracts or are designated and effective hedging instruments), other liabilities held for trading, and liabilities that an entity designates to be measured at fair value through profit or loss. After initial recognition, an entity cannot reclassify any financial liability.

Fair value option

An entity may, at initial recognition, irrevocably designate a financial asset or liability that would otherwise have to be measured at amortised cost or fair value through other comprehensive income to be measured at fair value through profit or loss if doing so would eliminate or significantly reduce a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') or otherwise results in more relevant information.



6.0 Impairment

Impairment of financial assets is recognised in stages:

- **Stage 1—as soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognised in profit or loss and a loss allowance is established. This serves as a proxy for the initial expectations of credit losses. For financial assets, interest revenue is calculated on the gross carrying amount (ie without deduction for expected credit losses).**

- Stage 2—if the credit risk increases significantly and is not considered low, full lifetime expected credit losses are recognised in profit or loss. The calculation of interest revenue is the same as for Stage 1. (**Gross carrying amount)**

- Stage 3—if the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the amortised cost (ie the gross carrying amount less the loss allowance which is the net carrying amount). Financial assets in this stage will generally be assessed individually. Lifetime expected credit losses are recognised on these financial assets.

Example 01 - Impairment loss – Individual loans

Max Bank is applying SLFRS 9 for the 2018 financial statements. The following is information about its loan portfolio at December 31, 2018.

- All of the loans were originated at a market rate of interest.

- Loans A , B, C and D share similar risk characteristics. They are mortgage loans in the same geographical area which are all secured by collateral.

- Max Bank considers all loans over 90 days to be credit-impaired based on historical experience with recovering the associated debt.

- Bank is unable to make the assumption that its loans have experienced a significant increase in credit risk when more than 30 days past due.

- The Max Bank ’s treasury department forecasts that interest rates will increase by 1% over the next 2 years. Based on historical data, Max Bank knows that a 1% increase in market interest rates usually results in a significant increase in credit risk for 10% of the variable rate mortgages that would otherwise be in Stage 1.

- Max Bank monitors certain loans more closely on an individual basis given their significance and unique characteristics. The following information is available without undue cost or effort on an individual loan basis.

Loan	Amount	Past Due Status	Other Information	PV of Expected Future Cost Flows, Including ECLs and the Expected Recoveries from Collateral
A (fixed rate)	Rs 200,000	90 days	The borrower has filed for bankruptcy.	Rs 180,000 (100% probability of default)
B (fixed rate)	Rs 150,000	Current	None	Not calculated
C (fixed rate)	Rs 120,000	Current	The borrower has breached several other covenants within the loan agreement and was recently arrested for embezzling money from his employer.	Rs 120,000
D (fixed rate)	Rs 50,000	60 days	The borrower recently lost his job due to an economic recession and was granted a Concession to skip payments.	Rs 37,000 (100% probability of default)

- Additional information by taking into account historical information, current conditions and forward-looking information, including actual loss experience and recoveries from the sale of collateral, is as follows:

Probability of Default in the Next 12 months	Lifetime Probability of Default	Loss Given Default
Fixed rate loans = 2%	Credit - impaired loans = 100%	All loans = 25%
Variable interest rate loans = 1%	Not credit - impaired loans = 5%	

Analysis:

The following table explains how the impairment allowance for Max Bank is calculated at December 31, 2018.

Loan	Amount	Stage	Rationale	Action Required Under SLFRS 9	ECL Allowance
1	Rs 200,000	3	Credit-impaired because 90 days past due and borrower bankruptcy	Recognize lifetime ECLs	(Rs 200,000 - Rs 180,000) × 100% = Rs 20,000
2	Rs 150,000	1	No significant increase in credit risk	Recognize 12 Months ECLs	150,000 × 25% × 2 % = Rs 750

3	Rs 120,000	2	Significant increase in credit risk	Recognize lifetime ECLs	Rs 120,000 - Rs 120,000 =Rs 0
4	Rs 50,000	3	Credit-impaired because of past due status and other events that have a detrimental effect on future cash flows	Recognize lifetime ECLs	(Rs 50,000 - Rs 37,000) × 100% = Rs 13,000

Total impairment loss under SLFRS 9 = Rs 33,750 (Rs 20,000 + Rs 750 + Rs 13,000)

Example No 02 - Impairment Calculation – Group Loan

Max Bank is applying SLFRS 9 for the 2018 financial statements. The following is information about its loan portfolio at December 31, 2018.

- All of the loans were originated at a market rate of interest.
- loans in NAGARA SAVIYA Group and JANA JAYA Group, share similar risk characteristics. They are mortgage loans in the same geographical area which are all secured by collateral.
- Max Bank considers all loans over 90 days to be credit-impaired based on historical experience with recovering the associated debt.
- Bank is unable to make the assumption that its loans have experienced a significant increase in credit risk when more than 30 days past due.
- The aging of Max Bank 's loans and the split between fixed and variable rates mortgages are as follows on December 31, 2018:

Loan	Total	Current	More than 30 Days Past Due	More than 60 Days Past Due	More than 90 Days Past Due
NAGARA SAVIYA Group – fixed rate mortgages	Rs 1700,000	Rs 1400,000	Rs 75,000	Rs 100,000	Rs 125,000
JANA JAYA Group – variable rate mortgages	Rs 600,000	Rs 500,000	Rs 20,000	Rs 30,000	Rs 50,000
Total	**Rs 2300,000**	**Rs 1900,000**	**Rs 95,000**	**Rs 130,000**	**Rs 175,000**

- The Max Bank's treasury department forecasts that interest rates will increase by 1% over the next 2 years. Based on historical data, Max Bank knows that a 1% increase in market interest rates usually results in a significant increase in credit risk for 10% of the variable rate mortgages that would otherwise be in Stage 1.

- Additional information for NAGARA SAVIYA Group and JANA JAYA Group taking into account historical information, current conditions and forward-looking information, including actual loss experience and recoveries from the sale of collateral, is as follows:

Probability of Default in the Next 12 months	Lifetime Probability of Default	Loss Given Default
Fixed rate loans = 2%	Credit - impaired loans = 100%	All loans = 25%
Variable interest rate loans = 1%	Not credit - impaired loans = 5%	

Answer

The following table explains how the impairment allowance for Max Bank is calculated at December 31, 2018.

Loan	Amount	Stage	Rationale	Action Required Under SLFRS 9	ECL Allowance
NAGARA SAVIYA Group	Rs 1,400,000 (current)	1	Not past due and no other information that indicates a significant increase in credit risk	Recognize 12-month ECLs	Rs 1,400,000 × 25% × 2% = Rs 7,000
NAGARA SAVIYA Group	Rs 75,000 (30 days past due) + Rs 100,000 (60 days past due) = Rs 175,000	2	More than 30 days past due; therefore, presumed to have experienced a significant increase in credit risk	Recognize lifetime ECLs	Rs 175,000 × 25% × 5% = Rs 2,188
NAGARA SAVIYA Group	Rs 125,000 (90 days past due)	3	90 days overdue and based on past experience these are considered credit-impaired	Recognize lifetime ECLs	Rs 125,000 × 25% × 100% = Rs 31,250
JANA JAYA Group	Rs 500,000 (current) × 90% (not affected by interest rate increase) = Rs 450,000	1	Not past due and no other information that indicates a significant increase in credit risk	Recognize 12-month ECLs	Rs 450,000 × 25% × 1% = Rs 1,125

JANA JAYA Group	Rs 20,000 (30 days past due) + Rs 30,000 (60 days past due) + 10% × Rs 500,000 (current but affected by interest rate increase) = Rs 100,000	2	More than 30 days past due; therefore ,presumed to have experienced a significant increase in credit risk and a portion experienced an increase in credit risk due to announced interest rate increase	Recognize lifetime ECLs	Rs 100,000 × 25% × 5% = Rs 1,250
JANA JAYA Group	Rs 50,000 (90 days past due)	3	Credit-impaired because 90 days past due	Recognize lifetime ECLs	Rs 50,000 × 25% × 100% = Rs 12,500

Total impairment loss under SLFRS 9 = Rs 55,313 (Rs 7000 + Rs 2,188 + Rs 31,250 + Rs 1,125 + Rs 1,250 + Rs 12,500)

7.0 Hedge accounting

The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or other comprehensive income.

Hedge accounting is optional. An entity applying hedge accounting designates a hedging relationship between a hedging instrument and a hedged item. For hedging relationships that meet the qualifying criteria in SLFRS9, an entity accounts for the gain or loss on the hedging instrument and the hedged item in accordance with the special hedge accounting provisions of SLFRS 9.

SLFRS 9 identifies three types of hedging relationships and prescribes special accounting provisions for each:

- fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognized firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

- cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.

- hedge of a net investment in a foreign operation as defined in LKAS 21.

When an entity first applies SLFRS 9, it may choose to continue to apply the hedge accounting requirements of LKAS 39, instead of the requirements in SLFRS 9, to all of its hedging relationships.

Practice Questions

Question No 01

One of the issues covered by SLFRS 9 *Financial Instruments* (revised July 2014) is the classification and measurement
of financial assets. The three possible measurement bases identified by the standard are:

- Amortized cost.
- Fair value through other comprehensive income.
- Fair value through profit or loss.

Required:

Explain how SLFRS 9 requires entities to select the appropriate measurement basis for a financial asset. You should include any options available to entities regarding classification in your explanation.

Answer

Under SLFRS9, the basis for classifying and measuring financial assets is the business model for managing the financial asset and the contractual cash ow characteristics of the financial asset. Where the business model for managing the financial asset is to hold the financial asset to collect the contractual cash ows and where the contractual terms of the financial asset give rise on specified dates to cash ows which are solely payments of principal and interest on the principal amount outstanding, then the financial asset is measured at amortized cost

Where the business model for managing the financial asset is to both hold the financial asset to collect the contractual cash ows and to sell the financial asset and where the contractual terms of the financial asset give rise on specifed dates to cash ows which are solely payments of principal and interest on the principal amount outstanding, then the financial asset is measured at fair value through other comprehensive income.

If a financial asset is not measured at amortized cost or fair value through other comprehensive income, then it is measured at fair value through profit or loss (the default category). An entity can make an optional irrevocable election on initial recognition that particular investments in equity instruments which would otherwise be measured at fair value through profit or loss be measured at fair value through other comprehensive income. This election is only possible if the equity investment is *not* ‘held for trading’

Question No 02

A retail entity supplies products to the public on three year deferred payment terms. On 1 January 2013 the entity supplies a product for a total price of Rs 13,310, payable on 1 January 2016. The credit rating of the customer is such that a relevant imputed annual rate of interest is 10%. The entity's year end is 31 December. Identify the Accounting treatment for the transaction.

Answer

On 1 January 2013 the total revenue from the sale would be split into:

(a) Revenue from the sale of goods of Rs 10,000 (Rs 13,310/(1.10) *3*. This is recognized immediately by crediting revenue and debiting receivables.
(b) Interest revenue of Rs 3,310 (Rs 13,310 - Rs 10,000). This is recognized over the three years.

Year ended 31st December (Rs)	Opening receivable (Rs)	Finance Income (10%) (Rs)	Closing receivable (Rs)
2013	10,000	1,000	11,000
2014	11,000	1,100	12,100
2015	12,100	1,210	13,310

Question No 03

On 1 April 2017, Epsilon loaned Rs 30 million to another entity. Interest of Rs 1·5 million is payable annually in arrears. An additional fnal payment of Rs 35·3 million is due on 31 March 2020. Epsilon incurred direct costs of Rs 250,000 in arranging this loan. The annual rate of interest implicit in this arrangement is approximately 10%. Epsilon has no intention of assigning this loan to a third party at any time.
Answer

Since the business model is to collect the contractual cash ows and the cash ows consist solely of the repayment of principal and interest, this asset is measured at amortised cost. The initial carrying amount of the financial asset will be Rs 30·25 million (Rs 30 million fair value + Rs 250,000 transaction costs) The finance income recorded under investment income category in the statement of profit or loss for the year ended 31 March 2018 will be Rs 3·025 million (Rs 30·25 million x 10%). The carrying amount of the financial asset in the statement of financial position at 31 March 2018 will be Rs 31·775 million (Rs 30·25 million + Rs 3·025 million – Rs 1·5 million).

Financial asset A/C

Cash	30 000 000	Cash	1 500 000
Transaction Cost	250 000		
P/L	3 025 000	C/d	31 775 000
	33 275 000		33 275 000
B/f	31 775 000		

Income Statement

Other Income	
- Investment Income	3 025 000

Financial position

Asset	
- Investment	31 775 000

Question No 04

On 1 April 2017, Epsilon purchased 500,000 shares in a key supplier – entity X. The shares were purchased in order to protect Epsilon's source of supply and Epsilon has no intention of trading in these shares. The shares cost Rs 2 per share and the direct costs of purchasing the shares were Rs 100,000. On 1 January 2018, the supplier paid a dividend of 30 cents per share. On 31 March 2018, the fair value of a share in entity X was Rs 2.25.

Answer

Since this is an equity investment which Epsilon has no intention of selling, Epsilon can measure the investment at fair value through other comprehensive income (provided irrevocable election on initial recognition has been made).

Since the financial asset is measured at fair value through other comprehensive income, the transaction cost (agent's commission) is included in the initial fair value of shares (500,000 x Rs 2 + Rs 100,000).

The carrying amount of the financial asset in the statement of financial position at 31 March 2018 will be Rs 1·125 million based on fair value of shares at the year end (500,000 x Rs 2.25)

The difference (fair value gain) of Rs 25,000 (Rs 1.125 million – Rs 1·1 million) will be recognized in other comprehensive income

Dividend income of Rs 150,000 (500,000 x 30 cents) will be recognised as other income in the statement of proft or loss.

Financial asset A/C

Cash (500 000 x 2)	1 000 000		
Transaction Cost	100 000		
OCI	25 000	C/d (500 000 x 2.25)	1 125 000
	1 125 000		1 125 000
B/f	1 125 000		

Income Statement

Other Income	
Divided Income (500 000 x .30)	150 000

OCI

OCI	
Investment Income	25 000

Statement of financial position

Asset	
Investment in shares	1 125 000

Question No 05

On 1 January 2018, Epsilon purchased 100,000 call options to purchase shares in entity Y – an unconnected third party. Each option allowed Epsilon to purchase shares in entity Y on 31 December 2018 for Rs 6 per share. Epsilon paid Rs 1·25 per option on 1 January 2018. On 31 March 2018, the fair value of a share in entity Y was Rs 8 and the fair value of a share option purchased by Epsilon was Rs 1.60. This purchase of call options is not part of a hedging arrangement.

Answer

The call option cannot be measured at amortized cost or fair value through other comprehensive income, so it must be measured at fair value through profit or loss.

The initial carrying value of the call option will be Rs 125,000 (100,000 x Rs 1.25). At the year end, the call option will be re-measured to its fair value of Rs 160,000 (100,000 x Rs 1·60). The fair value gain of Rs 35,000 (Rs 160,000 – Rs 125,000) will be recognised in the statement of profit or loss.

Financial asset A/C

Cash	125 000		
P/L	35 000	C/d	160 000
	160 000		160 000
B/f	160 000		

Income Statement

Other Income	
Investment Income	35 000

Statement of financial position

Asset	
Investment	160 000

Question No 06

Accounting for a financial liability at amortized cost

Apex PLC raises finance by issuing zero coupon bonds at par on the first day of the current accounting period with a nominal value of Rs 10,000. The bonds will be redeemed after two years at a premium of Rs 1,449. The effective rate of interest is 7%.

Required
Explain and illustrate how the loan is accounted for in the financial statements of Apex PLC.

Answer

	Opening Balance	plus imcome statement finance charge @7% on the opening balance	Less the cash paid	Closing balance, being the liability on the statement of financial position
Year 1	Rs 10,000	Rs 700	(Nil)	Rs 10,700
Year 2	Rs 10,700	Rs 749	(Rs 11,449)	Nil

Question No 07

Broad raises finance by issuing Rs 20,000 6% four-year loan notes on the first day of the current accounting period. The loan notes are issued at a discount of 10%, and will be redeemed after three years at a premium of Rs 1,015. The effective rate of interest is 12%. The issue costs were Rs 1,000.

Required
Explain and illustrate how the loan is accounted for in the financial statements of Broad.

Answer

Cash receivable - the nominal value less the discount on issue	(Rs 20,000x90%)	Rs 18,000
Less the transaction costs		(Rs 1,000)
Initial recognition of the financial liability		Rs 17,000

	Opening Balance	Plus income Statement finance charge @12% on the opening balance	Less the cash paid (6%x20,000)	Closing balance, being the liability on the statement of financial position
Year 1	Rs 17,000	Rs 2,040	(Rs 1,200)	Rs 17,840
Year 2	Rs 17,840	Rs 2,141	(Rs 1,200)	Rs 18,781
Year 3	Rs 18,781	Rs 2,254	(Rs 1,200)	Rs 19,835
Year 4	Rs 19,835	Rs 2,380	(Rs 1,200) (Rs 21,015)	Nil
Total Finance Costs		Rs 8,815		