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Financial Instruments:

LKAS 32, LKAS 39, SLFRS 7

Financial Instruments – The replacement project

- IFRS 9 (2009)
  Classification and measurement – assets
- IFRS 9 (2010)
- Classification and measurement – liabilities
- IFRS 9 (2013)
- General hedge accounting
- IFRS 9
  Classification and measurement – amendments
  New impairment model

Overview

- Completed standard substantially concludes project to replace IAS 39 *Financial Instruments: Recognition and Measurement*
- No convergence with US GAAP
- Effective date of 1 January 2018
- Applies retrospectively, with some exemptions

Bottom line

- Standard could have a major impact across an organisation – particularly for financial institutions
- Larger and more volatile bad debt provisions likely
- Companies need to start planning for transition, to understand the time, resources and changes to systems and processes needed

Financial instruments sub-modules

- **Introduction and scope**
- **Classification and measurement**
- Derivatives, embedded derivatives & financial guarantees
- **Recognition and derecognition**
- Impairment
- Hedge accounting
- **Classification as financial liabilities or equity**
- Presentation & disclosure

Financial Instruments: Introduction and Scope

LKAS 32, LKAS 39, SLFRS 7

Agenda – Introduction and scoping

- **Overview of the FI standards**
- **The basic definitions**
- **Scope**

Overview of the FI standards

Liability vs equity classification
Offsetting
IAS 32: Presentation

Classification and measurement
Recognition and derecognition
Derivatives
Hedge accounting
ecognition and measurement

Disclosures
IFRS 7: Disclosures

Classification and measurement
Recognition and derecognition
Hedge accounting
IFRS 9 (effective 1 January 2018)

Agenda – Introduction and scoping

- Overview of the FI standards
- **The basic definitions**
- Scope

Financial instruments

A financial instrument is a contract that gives rise to both:

a financial asset of one entity

&

a financial liability or equity instrument of another entity

Financial asset

Financial asset

- Cash
- Equity instrument of another entity
- Contractual right to receive cash or another financial asset or to exchange financial assets or financial liabilities under potentially favourable conditions
- Certain contracts settled in the entity's own equity

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Financial liability

Financial liability

- Contractual obligation to deliver cash or another financial asset or to exchange instruments under potentially unfavourable conditions
- Certain contracts settled in the entity’s own equity

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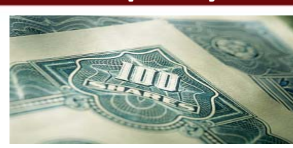
Equity



Equity

- Contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities

A question for you: Financial instruments

Which of the following items are financial instruments?

- Trade payables
- Forward exchange contract
- Patents and trademarks
- Cash-settled share-based payment liability
- Bond issued
- Tax liability
- Finance lease liabilities

If they are financial instruments, are they financial assets, financial liabilities or equity instruments?

Agenda – Introduction and scoping

- Overview of the FI standards
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- Scope

Scope exclusions (extract)

Certain financial instruments are excluded from the scope of IAS 39
Examples include:

- Interests in subsidiaries, associates and joint ventures (IAS 27, 28)
- Employer's rights and obligations under employee benefit plans (IAS 19)
- Financial instruments under share-based payment transactions (IFRS 2)
- Rights and obligations under insurance contracts (IFRS 4)
- Lease rights and obligations except for:
  - Lease receivables of a lessor which are subject to derecognition and impairment requirements of IAS 39
  - Finance lease payables of a lessee which are subject to the derecognition requirements of IAS 39 and
  - Derivatives embedded in leases

Financial guarantees and loan commitments

Financial guarantee contracts issued fall within the scope of
IAS 39 (unless accounted for under IFRS 4)

Certain loan commitments excluded from the scope of
IAS 39 but are subject to IAS 39 derecognition requirements

See separate module "Derivatives, embedded derivatives and financial guarantees" for more guidance on financial guarantees

Scope inclusion: Cntracts to buy / sell non-financial items

IAS 39 applies to certain contracts to buy or sell non-financial items

Can the contract be settled net in cash or another financial instrument?

- **yes** → Are they entered into in accordance with the entity's expected purchase, sale or usage requirements ("own-use" exemption)?
  - **yes** → Excluded from IAS 39
  - **no** → Included in IAS 39
- **no** → Excluded from IAS 39

Examples of non-financial items:
- Commodities such as gold oil wheat
- Aircraft
- Real estate

Net settlement of contracts to buy or sell non-financial items

Contract terms permit net settlement in cash or another financial instrument or by exchanging financial instruments

Entity has practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments**

The non-financial item is readily convertible to cash

Entity has a practice for similar contracts of taking delivery of the underlying and selling it within short term to generate a profit**

**** own use exemption not available**

A question for you: Scope

Which of the following items are within the scope of IAS 39?

- Forward contract to buy orange juice concentrate held by a juice manufacturer who uses all the quantity bought in its manufacturing process
- Forward contract to buy orange juice concentrate held by a bank – the contract allows the counterparty to settle it early by paying or receiving the fair value to/from the bank. The counterparty has often settled such contracts net
- Forward contract to buy sugar entered into by a chocolate manufacturer. The manufacturer often sells excess sugar bought as he typically buys more than he requires
- Financial guarantee held

Financial Instruments: Classification and measurement

LKAS 32, LKAS 39, SLFRS 7

Financial instruments sub-modules

- Introduction and scope
- Classification and measurement
- Derivatives, embedded derivatives & financial guarantees
- Recognition and derecognition
- Impairment
- Hedge accounting
- Classification as financial liabilities or equity
- Presentation & disclosure

Agenda – Classification and measurement

- **Classification**
- **Initial measurement**
- **Subsequent measurement**
- **Fair value**
- **Amortised cost**
- **Reclassification**

Classification of financial assets

Category	Definition
Financial assets at fair value through profit or loss (FVTPL)	♦ Financial assets held for trading ♦ Derivatives, other than some hedging instruments ♦ Financial assets designated to this category at initial recognition
Loans and receivables (L&R)	Non-derivative financial assets with: ♦ fixed or determinable payments; and ♦ not quoted in an active market
Held to maturity (HTM)	Non-derivative financial assets with: ♦ fixed or determinable payments ♦ fixed maturity; and ♦ intent and ability to hold to maturity
Available for sale (AFS)	♦ Non-derivative financial assets that are not classified into another category

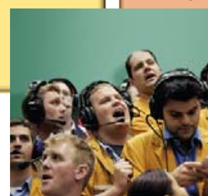
Classification of financial liabilities

Category	Definition
Financial liabilities at fair value through profit or loss (FVTPL)	♦ Financial liabilities held for trading ♦ Derivatives, other than some hedging instruments ♦ Financial liabilities designated to this category at initial recognition
Other financial liabilities (OFL)	All financial liabilities that are not classified as FVTPL

Held for trading

Acquired or incurred principally for purpose of selling or repurchasing it in the near term OR

On initial recognition it is part of portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short term profit taking OR



It is a derivative except if the derivative is a financial guarantee contract or a hedging instrument

Fair value option: Restrictions

- Only available at initial recognition
- Designation is irrevocable
- Only if either of the following conditions is met:

A hybrid contract with embedded derivatives unless:
- embedded derivative does not significantly modify cash flows or
- Separation is prohibited

OR

Designation results in more relevant information because of:
- elimination or reduction of accounting mismatch
  OR
- a group of financial assets/liabilities is managed and evaluated on a fair value basis

Held to maturity: Tainting

Is there a sale/transfer or change of intent/ability related to a HTM asset?

yes

- close to maturity so effect on fair value due to change of interest rate insignificant?
- substantially all of investment's original principal repaid? or
- sale attributable to isolated event beyond entity's control, that is non-recurring and could not have been anticipated?
    - the application guidance (IAS 39.AG22) provides specific situations in which case this condition is satisfied

no

Reclassification of remaining HTM portfolio into AFS

&

Use of HTM classification restricted in remainder of the current and next two financial years

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A question for you: Classification

Which classifications are allowed for the following financial instruments?

- Equity securities held
- Loan from associate
- Call deposits from customers
- Interest rate swaps (not used for hedge accounting)
- Redeemable preference shares held
- Debt securities held (exchange quoted)

Agenda – Classification and measurement

- Classification
- **Initial measurement**
- Subsequent measurement
- Fair value
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- Reclassification

Measurement at initial recognition

At initial recognition a financial instrument is measured at fair value

Transaction price is normally the best evidence of fair value on initial recognition *

Transaction costs included in initial measurement of financial instruments not classified as at FVTPL

A question for you: Initial measurement

- Lila-Tech invests in a zero coupon bond
  - Bond bought at a price lower than the nominal value which is repaid at maturity and which does not give rise to periodic interest payments
- Nominal amount of the bond L$ 100
- Purchase price L$ 80
- Directly attributable transaction costs L$ 4
- Lila-Tech classified the bond as L&R

At what amount should Lila-Tech recognise the zero coupon bond?

Agenda – Classification and measurement

- Classification
- Initial measurement
- **Subsequent measurement**
- Fair value
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Subsequent measurement

Category	Measurement	Recognition of fair value other than impairment
FVTPL	Fair value	Profit or loss
AFS	Fair value	OCI with the exception of FX differences on debt instruments
HTM L&R OFL	Amortised cost	Not relevant

Fair value exemption: applicable in rare circumstances to investments in equity instruments that do not have a quoted price in an active market and whose fair value cannot be reliably measured. Also applies to derivatives that are linked to and are settled by the delivery of such equity instruments.

FX= foreign exchange

Accounting for financial assets classified as AFS

Equity instruments	Debt instruments
Fair value changes recognised in OCI	Difference between fair value and amortised cost recognised in OCI
Upon impairment or disposal, cumulative amount in OCI reclassified to profit or loss	Upon impairment or disposal, cumulative amount in OCI reclassified to profit or loss
FX changes not recognised in profit or loss	FX changes recognised in profit or loss

Which statement is correct?

Equity securities held may be measured at amortised cost

Impairment related to derivatives is recognised in profit or loss

Fair value changes of AFS financial assets, other than impairment and FX differences on AFS debt instruments, are recognised in OCI

Impairments related to other liabilities are recognised in OCI

Agenda – Classification and measurement

- Classification
- Initial measurement
- Subsequent measurement
- **Fair value**
- Amortised cost
- Reclassification

IFRS 13

IFRS 13 includes a single definition of fair value for all assets and liabilities (not just financial instruments).

Fair value: General considerations

Fair value is a price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date.

Fair value is an exit price. An ‘exit price’ is the price that would be received to sell an asset or paid to transfer a liability at the measurement date.

The fair value measurement assumes that the transaction takes place in the “principal” market or, in its absence, in the “most advantageous” market

Fair value is estimated using assumptions that market participants would use, assuming that they act in their best economic interest

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Fair value: Hierarchal approach

Is there a quoted price for an identical item in an active market?

Yes

Price adjusted?

No

Level 1

No

Yes

Any significant unobservable inputs?

No

Level 2

Yes

Level 3

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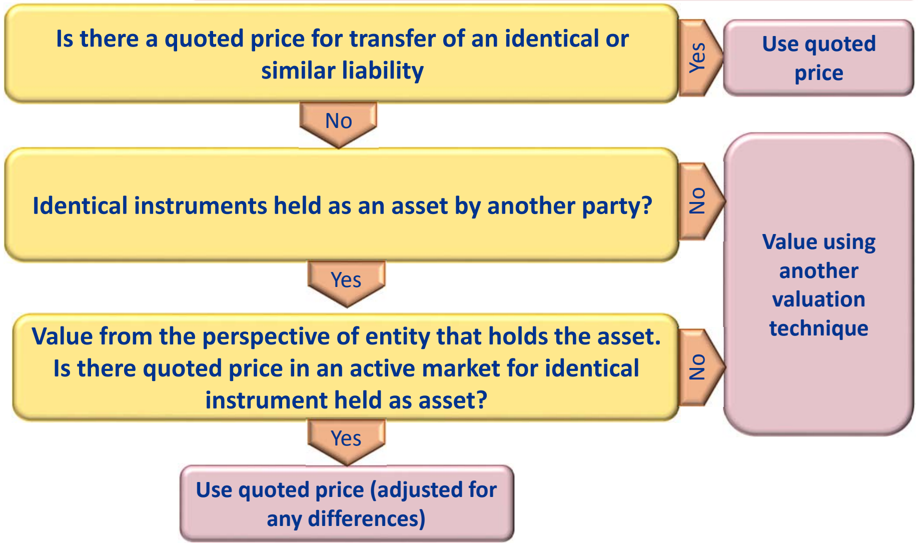
Fair value: Valuation techniques

The most reliable evidence of fair value is a quoted price in an active market.

When this is not available, measure fair value using a valuation technique that maximises the use of relevant observable inputs and minimises the use of unobservable inputs.

Bid-ask spread
-Use price within bid ask spread that is most representative of fair value in the circumstances

Fair value: Financial liability



Agenda – Classification and measurement

- Classification
- Initial measurement
- Subsequent measurement
- Fair value
- **Amortised cost**
- Reclassification

Amortised cost: Effective interest method

Effective interest method calculates amortised cost and allocates interest income or expense over relevant period

Effective interest rate exactly discounts estimated future cash flows, without taking account of future credit losses, to the net carrying amount

Effective interest rate is calculated on initial recognition

Difference between effective interest for a given period and the instrument's coupon and any other cash received is the amortisation

Re-estimation of cash flows

When expected cash flows from a financial instrument are revised, resulting revision adjusts the carrying amount of the financial instrument

Full adjustment recognised in profit or loss immediately

Floating rate financial instruments: effect of periodic re-estimation of cash flows to reflect movements in market interest rates alters effective interest rate

Specific requirements for reclassified financial assets

Agenda – Classification and measurement

- Classification
- Initial measurement
- Subsequent measurement
- Fair value
- Amortised cost
- **Reclassification**

Reclassification of financial assets

- P–permitted in certain circumstances
- R–required in certain circumstances
- X–not allowed

* Derivatives may be designated as hedging instruments subsequent to initial recognition

From \ To	FVTPL	AFS	HTM	L&R
FVTPL (non derivatives held for trading)	NA	P	P	P
FVTPL (derivatives* or designated)	NA	X	X	X
AFS	X	NA	P	P
HTM	X	R	NA	X
L&R	X	P	X	N/A

Classification of financial assets – LKAS 39 vs SLFRF9

IAS 39		IFRS 9
HFT	*FV – through P&L*	FV – through P&L
AFS	*FV – through OCI*	FV – through OCI
HTM	*Amortised cost*	Amortised Cost
L&R	*Amortised cost*	

Financial Instruments: Equity / Liability classification

LKAS 32, LKAS 39, SLFRS 7

Agenda – Equity Liability Classification

- **The basics**
- Classification
- Reclassification
- Treasury shares
- Distributions and transaction costs

The basics

An entity classifies financial instruments, or its components:

- upon initial recognition in accordance with the substance of the contractual arrangement and
- the definitions of financial assets, financial liabilities and equity instruments into:

Financial assets	Financial liabilities	Equity instruments (issued)
		

Agenda – Equity Liability Classification

- The basics
- **Classification**
- Reclassification
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Conditions to classify as equity instrument

<u>Contractual obligation</u> to deliver cash / another financial asset to another party, or to exchange financial assets / financial liabilities with another party under potentially unfavourable conditions (for the issuer of the instrument).

no

yes

If the instrument will or may be settled in the issuer's own equity instruments:

- Is it a non-derivative that comprises an obligation for the issuer to deliver a fixed number of its own equity instruments; or
- Is it a derivative that will be settled only by the issuer exchanging a fixed amount of cash or other financial assets for a fixed number of its own equity instruments?

no

yes

Fixed for fixed requirement

Settlement options in derivative instruments

Do all settlement alternatives result in equity classification?

yes

no

Example: Derivative financial instrument with a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash

Derivative contracts settled in own equity

Does financial instrument give holder the right to acquire fixed number of the entity's own equity instruments for a fixed amount of any currency?

yes

Does entity offer financial instrument pro rata to all existing owners of same class of its own non-derivative equity instruments?

no

yes

Contingent settlement provisions

Does instrument contain contractual obligation to deliver cash or another financial asset depending on outcome of an uncertain future event that is beyond control of both the issuer and the holder of the instrument?

yes

- **Is the part of contingent settlement provision that could require settlement in cash or another financial instrument not genuine?**

OR

- **Can issuer be required to settle in cash or another financial asset only in event of its own liquidation?**

no

yes

Obligation to acquire own equity truments and exceptions to classification

Does holder have right to put financial instrument back to issuer for cash / other financial assets (puttable instrument)?

OR

Does financial instrument contain contractual obligation for the entity to deliver to the holder a pro rata share of its net assets only on liquidation?

yes

Are specific conditions in IAS 32.16A-D satisfied?

no

yes

By exception

Compound instruments

Financial liability component & Equity component

Split accounting:
Issuer of compound instruments classifies the liability and equity components of the compound instrument separately as financial liability and equity

Allocation of initial carrying amount of a compound instrument

Fair value of entire compound instrument
(e.g. convertible bond L$ 100)

1. **Determine fair value of liability component including any embedded derivatives (e.g. L$ 60)**

2. Residual equity instrument
(e.g. conversion option L$ 40)

A question for you: Classification (1)

Assess the classification (financial liability, equity or compound instrument) of the following financial instruments in the financial statements of the issuer

- Ordinary shares
- Redeemable preference shares with a 5% fixed annual dividend which is payable only if there are sufficient distributable profits available
- Redeemable preference shares with discretionary dividends
- Convertible bond paying fixed interest that is convertible into a fixed number of shares

Derivative financial instruments: Obligation to purchase own equity instruments

Does derivative financial instrument create (potential) obligation for an entity to purchase its own equity instruments for cash / another financial asset?

Yes

Recognise financial liability measured at present value of redemption amount irrespective of classification as financial liability or equity

If contract qualifies as equity instrument:

- Financial liability is recognised against a debit to equity
- Upon expiration of the obligation without settlement the financial liability is derecognised against a credit to equity

A question for you: Classification (2)

Assess the classification (financial liability, equity or compound instrument) of the following financial instruments in the financial statements of the issuer

Assess whether a liability should be recognised due to a (potential) obligation to purchase its own shares

- A warrant giving the holder a right to subscribe for a fixed number of the issuer's shares for a fixed amount of cash
- A forward contract that commits the issuer to repurchase a fixed amount of its own shares for a fixed amount of cash
- A written option to repurchase a fixed amount of own shares for a fixed amount of cash
- Written share option that the issuer can decide to settle either in cash or by delivering own shares

Agenda – Equity Liability Classification

- The basics
- Classification
- **Reclassification**
- Treasury shares
- Distributions and transaction costs

Reclassification

- **Did the entity amend the contractual terms <u>or</u>**
- **Have the effective terms of the instrument changed <u>or</u>**
- **Is there a relevant change in the composition of the entity?**

yes

Reclassification subsequent to initial recognition may be required

E.g.:

- Lila-Tech issued perpetual shares which carry the right to receive discretionary dividends. Lila-Tech amends the terms of its perpetual preference shares such that redemption is required in the event of a change of control of the entity.

Reclassification from equity to liability

Is there a reclassification from equity to liability?

yes

- **Derecognise carrying amount of equity instrument**
- **Recognise liability at fair value**
- **Recognise an adjustment in equity for the difference**

Example:

- Lila-Tech issued perpetual shares for L$ 100 that carry the right to receive discretionary dividends (classified as equity). Lila-Tech amends the terms such that redemption is required in the event of a change of control of the company.
- Fair value of the perpetual shares are L$ 120
- On reclassification, recognise an adjustment in equity for L$ 20

Reclassification from liability to equity

Has debt been swapped for equity as a result of renegotiation of terms of a financial liability?

yes

- **Derecognise carrying amount of financial liability**
- **Recognise equity instruments (consideration paid) at fair value if reliably measurable, or if not reliably measurable then at fair value of derecognised liability**
- **Recognise difference in profit or loss**

Example:
- Lila-Tech exchanges debt (carrying amount L$ 100) for equity (fair value L$ 120)
- Derecognise liability and recognise equity instruments and a loss of L$ 20 in profit or loss

Agenda – Equity Liability Classification

- The basics
- Classification
- Reclassification
- **Treasury shares**
- Distributions and transaction costs

Treasury shares

Are own equity instruments acquired?

yes

Debit amount paid directly to equity

Are own equity instruments sold?

yes

Credit amount received directly to equity

No gains / losses recognised in profit or loss on:
- Any purchase, sale, issue or cancellation of own equity instruments; OR
- With respect of any changes in the value of treasury shares

Agenda – Equity Liability Classification

- The basics
- Classification
- Reclassification
- Treasury shares
- **Distributions and transaction costs**

Distributions and transaction costs

Distributions

Transaction costs

Recognise in profit or loss

Recognise directly in equity

Classification of a financial instrument issued determines treatment of distributions and transaction costs related to the instrument

Thank you.