FINANCIAL INSTRUMENTS (IFRS 9)

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1. Objective of IFRS 9

IFRS 9 provides principles for:

- **Classification and measurement** of financial assets and liabilities
- **Impairment** using the **Expected Credit Loss (ECL)** model
- **Hedge accounting**
- **Derecognition** of financial instruments

It replaces IAS 39 and aims to reflect the **economic substance** of financial instruments more faithfully.

PART A — CLASSIFICATION & MEASUREMENT

2. Financial Assets: Classification Logic

Classification is based on **two tests**:

2.1 Business Model Test

How the entity manages the asset:

1. **Hold to collect** contractual cash flows
2. **Hold to collect and sell**
3. **Other** (e.g., trading)

2.2 SPPI Test (Solely Payments of Principal and Interest)

Contractual cash flows must be **only principal + interest** on the principal amount outstanding. Interest = consideration for:

- Time value of money
- Credit risk
- Liquidity risk
- Profit margin

If SPPI **fails**, the asset is **mandatorily Fair Value Through Profit or Loss (FVTPL)**.

3. Classification Categories

3.1 Amortised Cost (AC)

Conditions:

- Business model = **hold to collect**
- SPPI = **pass**

Measurement:

- Initially at **fair value + transaction costs**
- Subsequently at **amortised cost** using **Effective Interest Rate (EIR)**
- Impairment: **Expected Credit Loss (ECL) model applies**

Examples:

- Trade receivables
- Loan receivables
- Intercompany loans

3.2 Fair Value Through Other Comprehensive Income (FVOCI)

Conditions:

- Business model = **hold to collect + sell**
- SPPI = **pass**

Measurement:

- Fair value (FV) changes → **OCI**
- Interest income → **P/L**
- Impairment → **P/L**
- On disposal → **reclassifying from OCI to P/L**

Examples:

- Debt instruments held for liquidity management

3.3 Fair Value Through Profit or Loss (FVTPL)

Used when:

- Business model = trading
- SPPI = **fail**
- Entity elects FVTPL to avoid accounting mismatch
- Equity instruments (unless FVOCI election made)

Measurement:

- All FV changes → **P/L**

Examples:

- Derivatives
- Equity investments (default category)
- Complex debt instruments

4. Equity Instruments

Equity instruments **cannot** be measured at amortised cost.

Options:

1. **Default: FVTPL**
2. **Irrevocable election: FVOCI (no recycling)**
    - Dividends → P/L
    - FV changes → OCI
    - On disposal → OCI **not recycled**

5. Financial Liabilities

Most financial liabilities are measured at **amortised cost**.

Exceptions:

- **FVTPL liabilities** (e.g., held for trading, derivatives)
- **Own credit risk** changes → OCI
- **Financial guarantee contracts**
- **Loan commitments**

PART B — IMPAIRMENT (EXPECTED CREDIT LOSS MODEL)

6. Overview

IFRS 9 uses a **forward-looking** impairment model:

- Applies to **financial assets at AC or FVOCI**
- Uses **Expected Credit Losses (ECL)**

- Requires **probability-weighted** outcomes
- Incorporates **reasonable and supportable forward-looking information**

7. The Three-Stage Model

Stage 1 — Performing Assets

- Credit risk has **not increased significantly**
- Recognise **12-month ECL**
- Interest revenue based on **gross carrying amount**

Stage 2 — Underperforming Assets

- Credit risk has **increased significantly**
- Recognise **lifetime ECL**
- Interest revenue still based on **gross carrying amount**

Stage 3 — Credit-Impaired Assets

Indicators:

- Default
- Significant financial difficulty
- Breach of contract
- Concessions granted

Effects:

- Recognise **lifetime ECL**
- Interest revenue based on **net carrying amount** (after loss allowance)

8. ECL Formula

General formula:

$$\mathrm{ECL} = \mathrm{PD} \times \mathrm{LGD} \times \mathrm{EAD}$$

Where:

- **PD** = Probability of Default
- **LGD** = Loss Given Default
- **EAD** = Exposure at Default

9. Simplified Approach

Used for:

- **Trade receivables**
- **Contract assets**
- **Lease receivables**

Rules:

- No staging
- Always recognise **lifetime ECL**
- Use **provision matrix**

10. Example (Simplified Approach)

Data

Trade receivables ageing:

- Current: R500 000 → loss rate 1%
- 30 days past due: R200 000 → loss rate 5%
- 60 days past due: R100 000 → loss rate 10%
- 90+ days: R50 000 → loss rate 40%

Calculation

- Current: R500 000 × 1% = R5 000
- 30 days: R200 000 × 5% = R10 000
- 60 days: R100 000 × 10% = R10 000
- 90+ days: R50 000 × 40% = R20 000

Total ECL = R45 000

Journal Entry

Dr Credit losses (P/L)	R45 000	
Cr Allowance for credit losses (SoFP)		R45 000

PART C — DERECOGNITION

11. Derecognition of Financial Assets

Derecognise when:

- Contractual rights to cash flows **expire**, OR
- Asset is **transferred**, and:
    - **Risks and rewards** substantially transferred, OR
    - Control is relinquished

If risks and rewards **not** transferred → continue recognising.

12. Derecognition Example

An entity sells receivables of R1 000 000 for R950 000. Risks and rewards substantially transferred.

Journal entry:

- Dr Bank R950 000
- Dr Loss on sale of receivables R50 000
- Cr Trade receivables R1 000 000

PART D — HEDGE ACCOUNTING

13. Types of Hedges

1. **Fair Value Hedge**
2. **Cash Flow Hedge**
3. **Net Investment Hedge**

14. Fair Value Hedge

Objective: hedge exposure to **changes in fair value**.

Accounting:

- Hedged item → FV changes in **P/L**
- Hedging instrument → FV changes in **P/L**

15. Cash Flow Hedge

Objective: hedge exposure to **variability in cash flows**.

Accounting:

- Effective portion → **OCI**
- Ineffective portion → **P/L**
- When hedged item affects P/L → recycle OCI to P/L

16. Hedge Effectiveness Requirements

Must be:

- **Economic relationship**
- **Credit risk does not dominate**
- **Hedge ratio** consistent with risk management

17. DISCLOSURE REQUIREMENTS

Entities must disclose:

- Risk management strategy
- Credit risk, liquidity risk, market risk
- ECL methodology
- Reconciliation of loss allowance
- FV hierarchy (Level 1, 2, 3)