Classification and measurement of Financial Instruments: IFRS 9

Introduction:

The classification and measurement of financial instruments is one of the most important accounting issues for reporting the values of assets and liabilities in financial statement. Classification determines how financial instruments are to be categorised and the measurement deals with valuation of that instruments. Thus classification and measurement, both becomes one of the important criteria for accounting of financial instruments including derivatives. IFRS 9 establishes specific categories into which the financial assets and liabilities must be classified. This article highlights how the financial assets and liabilities are to be classified and measured in accordance with IFRS 9: Financial Instruments and how this classification and measurement may impact financial instruments of an organisation.

Review of Literature:

Companies present their financial position through various financial statements. In this regard, accounting standards provide guidance on how accounting information should be recorded, reported and interpreted. According to Porwal (2006), Standardization helps to reduce wide judgmental intuition and discretion, which has reduced the work of the external auditor considerably. According to Ikpefan & Akande (2012), IFRS employs a uniform, single and consistent accounting framework that will gravitate towards General Accepted Accounting Practice Kingsley, Gina & Vivian (2014), opined that IFRS refers to a series of accounting pronouncements published by the International Accounting Standards Board to help preparers of financial statements, throughout the world, produce and present high quality, transparent and comparable financial information. IASB issues IFRS time to time for guiding accounting and reporting purpose. The IFRS 9 Financial Instruments replaces the accounting standard IAS 39. According to Dorval (2015), the resulting business model test now relies more on the judgment of senior management and will therefore provide limited implementation guidance for rule-based procedures. Bank for International Settlements (South African Reserve Bank, 2017) states that, the great financial crisis of 2007-09 marked the systemic costs of a delayed recognition of credit losses on the part of banks and other lenders. The application of the existing accounting standards at that time was seen as having prevented banks and financial institutions from provisioning appropriately for credit losses likely to arise from emerging risks. These delays resulted in the recognition of credit losses. Gradually excessive lending during the boom and lack of provision of credit losses and forced a sharp reduction in the subsequent ruined. The previous accounting standard rules were built on pre-defined asset class categories but the new rules under IFRS 9 Financial Instruments are based on the business model and supported by the cash-flow characteristics.

Methodology of the study:

The proposed study is a descriptive one. Qualitative information from secondary sources is used for the study. Accounting standards issued by IASB and resource materials published by different accounting and audit firms are the main secondary sources for the purpose. With the aim of studying on classification and measurement of financial instruments and it impacts in financial statement, IFRS 9 is analyzed.

Classification of financial asset:

The classification of financial assets are done on the basis of measurement, namely amortized cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVPL). Every financial asset needs to be categorised for measurement purpose on the basis of 'business model test' and 'solely payments of principal and interest (SPPI) test'. If an asset passes through both of the tests the asset would be categorised as amortized cost or FVOCI otherwise it would be considered as FVPL.

What is 'Business Model' test?

According to IFRS 9, a business model test refers to the way of managing its financial assets in order to generate cash flows. These business models are determined at a level that reflect how groups of financial assets are managed together to achieve a particular business objective rather than an individual financial instrument. IFRS 9 states that identifying business models is a matter of fact that is typically observable through an entity's activities. Based on the objectives, entity needs to classify the assets as 'hold to collect' or 'hold to collect and to sell' or 'other'. Many entities may only have one business model but it is possible to have more than one. Application of business model test involves the following basic steps:

> Classify necessary financial asset into separate groups or portfolios according to the way they are managed;
> Identify the objectives the entity uses in the course of its business to manage each grouping or portfolio;
> Based on those objectives, classify each group or portfolio as being 'held to collect' 'held to collect and to sell' or 'other'. These objectives can be classified as follows:

i.   'Hold to collect' model test:

The objective of the 'hold to collect' business model is to hold financial assets to collect their contractual cash flows, rather than with a view by selling the assets to generate cash flows. But this 'hold-to-collect' business model does not always require that financial assets are held until their maturity. Nevertheless, it is expected that sales would be incidental to this business model and consequently an entity will need to assess the nature, frequency and significance of any sales occurring.

ii. Hold to collect and sell

The objective of business model here is both to collect the contractual cash flows and at the same time to sell the financial asset. Here both, collecting cash flows and selling assets are integral. This business model, in contrast to the 'hold to collect' business model, typically involves greater frequency and volume of sales.

iii. Other

Other business models are all those that do not meet the 'hold to collect' or 'hold to collect and sell' qualifying criteria.

What is 'SPPI' test?

The contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding on a specified date with a basic lending arrangement.

In accordance with IFRS 9, the financial assets are classified on the basis of business model test and SPPI test as follows:

A. Amortized Cost

A financial asset, especially debt instruments, is measured at amortized cost if both of the following criteria are met:

- The business model test : to pass this test, the asset must be held to collect its contractual cash flows rather than to sell the asset to realize any capital gain; and
- The cash flow characteristics test: to pass this test, the asset's contractual cash flows must represent solely payments of principal and interest (SPPI) at a specified date.

Few examples of financial instruments that are likely to be classified and accounted under amortised cost according to IFRS 9 include trade receivables, loan receivables with 'basic' features, investments in term deposits at standard interest rates, investments in government bonds etc.

B. Fair value through other comprehensive income (FVOCI)

A financial asset is measured at fair value through other comprehensive income (FVOCI), if both of the following criteria are met:

- The business model test : The objective of the business model is achieved both by collecting contractual cash flows and selling financial assets; and
- The cash flow characteristics test: The asset's contractual cash flows represent SPPI.

This classification applies to the changes in equity instruments during a period resulting from transactions and other events. Financial assets included within the FVOCI category are initially recognized and subsequently measured at fair value and the changes in the carrying amount needs to be recorded through OCI.

C. Fair value through profit or loss (FVPL)

This is the normal default classification for financial assets. All instruments which do not come to the classifications of amortized cost or FVOCI must be categorised under FVPL. In this case generally the financial assets are being held and then traded to take advantage of changes in fair value. This classification includes any financial assets held for trading purposes and also includes derivatives, unless they are part of a properly designated hedging arrangement. Financial assets are recognized within the FVPL category should be measured at fair value with all changes recorded through profit or loss.

Nevertheless an entity can elect to classify a financial asset at FVPL regardless of business model and solely payments of principal and interest model assessment. The use of FVPL would *eliminate* or significantly reduce a measurement or recognition inconsistency *or* accounting mismatch. An entity can changes its business model for managing financial assets but when and only when change occurs, it must reclassify all affected financial assets.

Classification of financial liability:

In accordance with IFRS 9 classification of financial liability remains largely unchanged from IAS 39. The classification is as follows:

A. Financial liabilities at fair value through profit or loss (FVTPL)
This will include financial liabilities incurred for trading purposes and also all derivatives that are not part of a hedging arrangement. Examples are currency rate swaps (not designated in a hedging relationship), Commodity futures/option contracts (not designated in a hedging relationship) etc.

B. Financial liabilities measured at amortised cost
If financial liabilities are not held for trading they need to be classified as at amortised cost. Examples of such kind of liabilities are trade payables, bank borrowings etc.

Measurement of financial asset:

For accounting purpose the measurement becomes an important issue for any kind of financial assets and liabilities. The measurement is done at two stages –initial recognition and subsequent measurement.

A. Measurement at initial recognition

Financial assets shall be initially measured at:

- **Fair value**: All financial instruments fall under the classification of (i) at fair value through profit or loss (FVTPL) are to be measured at fair value;

- **Fair value plus transaction cost**: All other financial instruments fall under the classification of (ii) at amortized cost or (iii) fair value through other comprehensive income are to be measured at fair value plus transaction cost.

B. Measurement at subsequent stages

Subsequent measurement depends on the category of a financial asset**.** After initial recognition, financial assets are either measured at amortised cost or at fair value subsequently. The IFRS 9 divides all the financial assets in to two classes-those measured at amortized cost and those measured at fair value.

- Measured at amortised cost: Financial assets included within this category are initially recognised at fair value but subsequently measured at amortised cost if (i) the asset is held to collect its contractual cash flows; and (ii) the asset's contractual cash flows represent 'solely payments of principal and interest'.

- Measured at fair value: A financial asset classified under FVOCI or FVPL is measured at fair value.

Measurement of financial liability:

A. Measurement at initial stage

Financial liability shall be initially measured at:

C. **Fair value**: all financial instruments fall under the classification of (i) at fair value through profit or loss;

D. **Fair value plus transaction cost**: all other financial instruments fall under the classification of (ii) at amortized cost.

B. Subsequent measurement:

Once again it can be said that subsequent measurement depends on the category of a financial liability. All financial liabilities are measured at amortized cost except for financial liabilities which falls under the category of "Financial liabilities at fair value through profit or loss". Such liabilities include derivatives (other than derivatives which are designated as hedging instruments), other liabilities held for trading, and liabilities that an entity designates to be measured at fair value through profit or loss.

Impacts of classification and measurement

IFRS 9 introduces principle based classification and measurement approach replacing rules based approach for accounting purpose.

A financial asset is classified as subsequently measured at amortised cost if it satisfies (i)'Hold-to-collect' business model test and (ii) SPPI contractual cash flow characteristics test. Only a debt instrument can be qualified to be measured at amortised cost. Because an equity instrument can satisfy the first condition but never would be capable of giving rise to solely payments of principal and interest.

A financial asset is measured at fair value through other comprehensive income (FVOCI) under IFRS 9 if it satisfies (i) 'Hold-to-collect and sell' business model test and (ii) SPPI contractual cash flow characteristics test. Here certain debt instruments like as government bonds where the investment period is likely to be shorter than maturity and all equity investments satisfying both the conditions belongs to this category.

Fair value through profit or loss (FVTPL) is the residual category in IFRS 9. A financial asset is classified and measured at FVTPL if the financial asset is (i) held-for-trading financial asset
(ii) A debt instrument that does not qualify to be measured at amortised cost or FVOCI (iii) an equity investment which the entity has not elected to classify as at FVOCI (iv) a financial asset where the entity has elected to measure the asset at FVTPL under the fair value option (FVO).

Financial liabilities are measured at amortised cost (i) unless the financial liability is held for trading and (ii) or the entity does not elect to measure the financial liability at FVTPL. On the other a financial liability is measured at FVTPL if (i) the financial liability is held for trading and (ii) or the entity elects to measure the financial liability at FVTPL. After initial recognition, an entity cannot reclassify any financial liability. Thus no changes were introduced regarding classification and measurement of financial liabilities, except for the recognition of changes in own credit risk in other comprehensive income for liabilities designated at fair value through profit or loss.

The change of classification and measurement will particularly affect all the debt and equity instruments and the new approach of classification and measurement including the new FVTOCI category, provides opportunities for financial institutions to reassess the measurement basis of the existing loan portfolios and designate the portfolio to reflect and achieve an outcome consistent with the organization's objectives.

Financial statement impact of IFRS 9

Liabilities	Impact	Assets	Impact

Trading liabilities	Low	Cash and cash equivalents	Low
Derivative liabilities for risk management	Low	Trading assets	Low
Deposits due to customers	Medium	Derivative assets for risk management	Low
Debt securities issued	Medium	Loans and advances to banks	Medium
Provisions	Medium	Loans and advances to customers	High
Deferred tax liabilities	Medium	Investment securities	High
		Current tax assets	Medium
		Property, plant and equipment	Medium
		Intangible assets	Medium
		Deferred tax assets	Medium

Source: Compiled from Financial instruments: A summary of IFRS 9 and its effects; EY, March 2017

Conclusion

Business organisation holds assets and liabilities to generate cash flow but it seems to represent over or under value in some cases. This over and under valuation of financial instruments does not represent the actual financial position of the business organisation. IFRS 9 talks about the classification and measurement of financial assets to check this unprecedented situation to protect the business in future from price risk. IFRS 9 replaces the multiple classification and measurement models for financial instruments with a simple model. According to the standard assets are to be categorised in amortised cost and fair value (FVTOCI and FVTPL). How an asset to be classified and measured will depend on business model and cash flow characteristics of the asset. The principle based standard introduces a logical approach for classification and measurement of financial instruments. These classification and measurement are likely to have a significant impact on entities that have significant financial assets and in particular financial institutions. IASB's IFRS 9 has emerged and been implented in recent times to curb financial crisis; however, its effect can be felt eventually.

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