IFRS 9
Financial instruments

1. Objective

The Standard establishes:

- principles for classifying and measuring financial assets and liabilities;
- principles for the derecognition of assets and liabilities;
- a single impairment method for assessing financial assets.

The Standard's general approach takes into account **the manner in which an entity manages its financial instruments** (i.e., its "business model") and the contractual features of cash flows generated from financial assets.

This Standard aims at improving the comparability and facilitating an understanding of financial statements by presenting more relevant and useful information to investors and other users.

IFRS 9 must be applied by all entities to all types of financial instruments except:

- interests in subsidiaries, associates and joint ventures that are accounted for in accordance with IFRS 10, IAS 27 or IAS 28. However, these Standards require or permit an entity to account for these investments in accordance with some or all of the requirements of IFRS 9. Entities must also apply IFRS 9 to derivatives on such investments unless the derivative meets the definition of an equity instrument of the entity in IAS 32.
- rights and obligations under leases to which IFRS 16 Leases applies, except for the following items:
  - ✓ lease receivables recognised by a lessor, which are subject to the derecognition and impairment requirements of this Standard;
  - ✓ lease liabilities recognised by a lessee, which are subject to derecognition under this Standard;
  - ✓ derivatives that are embedded in leases.
- employers' rights and obligations under employee benefit plans, to which IAS 19 applies;
- financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32;
- rights and obligations arising under IFRS 17, unless the derivative is not itself a contract within the scope of IFRS 17, in which case IFRS 9 will apply to this

derivative;

- any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of IFRS 3 Business Combinations at a future acquisition date. The term of the forward contract must not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction;
- loan commitments other than related to derecognition and impairment for which IFRS 9 applies;
- financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 applies, except for certain contracts within the scope of IFRS 9;
- rights to payments to reimburse the entity for expenditure that it is required to make to settle a liability that it recognises as a provision in accordance with IAS 37;
- rights and obligations within the scope of IFRS 15, except for those which IFRS 15 requires to be recognised according to IFRS 9.

2. Scope

The **classification of a financial asset**, when initially recognized, is carried out taking into account the entity's business model and the specific contractual cash flow characteristics of the asset, namely:

- at **amortized cost:**
  - ✓ if it is held with the objective of holding assets in order to collect contractual cash flows, and;
  - ✓ its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest outstanding (primarily debt instruments);

- at **fair value through Other Comprehensive Income:**
  - ✓ if the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets;
  - ✓ its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest outstanding (primarily debt instruments)

- at **fair value through profit or loss** for assets that do not meet the criteria for measurement at amortized cost or through Other Comprehensive Income (OCI), although an entity may make an irrevocable election at initial recognition for particular investments in equity instruments that would otherwise be measured at fair value if this eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch).

Example 1: An entity holds bonds in order to collect contractual cash flows. Because of exceptional circumstances in the form of cash requirements following the purchase of new company headquarters, the entity sold 8% of its bond portfolio.

Question: Is it still possible to regard the economic objective being pursued by the entity is to hold financial assets in order to receive contractual cash flows?

Answer: Even if the entity takes into account the fair value of financial assets from a cash point of view (i.e. the amount it would obtain if it sold them), its business objective continues to be hold these bonds and collect the contractual cash flows. Carrying out a few sales (8%), because of a particular need for cash, does not run counter to the entity's business objective and the amortised cost method is still appropriate.

Example 2: An entity A is following an economic model that has the objective of granting loans to clients in order to subsequently sell these loans to a securitization vehicle B that issues instruments for investors. The entity granting the loans controls the securitization vehicle and includes it in its consolidated financial statements. The securitization vehicle collects contractual cash flows coming from the loans and transmits them to the investors. These portfolios may or may not include financial assets that are bad debts. If the amounts due on a loan are not paid on time, the securitization vehicle B attempts to obtain contractual cash flows through a variety of ways.
For example, it may be assumed that the loans continue to be recorded in the consolidated statement of financial position since they have not been derecognized by the vehicle.

Question: Is it possible to consider that the economic objective pursued by the entity is to hold financial assets in order to receive contractual cash flows?

Answer: Consolidated group A granted loans with the aim of holding them to collect contractual cash flows (via securitization vehicle B). The fact that there is bad debt or late payments does not alter the consolidated group's objective (the means of obtaining the reimbursement having been implemented by the securitization vehicle B).
Nonetheless, entity A granted the loans and has the aim of collecting cash flows from the completion of these loans via the sale to securitization vehicle B. Consequently, for the needs of its separate financial statements, it would not be considered to be managing this portfolio with the aim of receiving contractual cash flows.

Following initial accounting treatment, the financial assets must subsequently

be measured. The assets recorded at amortized cost are subject to the impairment rules (adjustment of the asset value if the initial fair value differs from the transaction price).

A **financial liability**, when initially recognized, may be classified/measured:

- at **amortized cost** by using the effective interest rate method except for the following cases:
  - ✓ a financial liability at fair value through profit or loss;
  - ✓ a financial liability incurred when a financial asset transfer does not meet the derecognition conditions or when the continuing involvement approach applies;
  - ✓ financial guarantee contracts;
  - ✓ commitment to provide a loan at a below-market interest rate;
  - ✓ contingent consideration recognised by an acquirer in a business combination to which IFRS 3 applies;

- at **fair value through profit or loss**, upon designation, without any subsequent modifications possible, if it meets one of the two following conditions:
  - ✓ if this treatment reduces an accounting mismatch in the measurement of assets or liabilities or of the recognition of profits or losses on different bases;
  - ✓ if the management of a group of assets and financial liabilities and the evaluation of its performance are based on fair value (in accordance with the risk or investment management strategy).

The subsequent measurement of the financial liabilities is recognized at amortized cost by using the effective interest rate method with the same exceptions as the initial recognition.

An **embedded derivative** is one of the two components of a hybrid contract that also includes a non- derivative host. If the host contract is a financial asset as understood under the present Standard, the hybrid contract is analyzed in its entirety to determine whether it may be qualified as a basic debt instrument. If, on the other hand, the host contract is a financial liability or a non-financial contract, the embedded derivative must be separated from the host contract and recognized as a derivative according to the present Standard if it fulfills the following three cumulative conditions:

- the economic characteristics and the risks of the embedded derivative are not closely related to those of the host contract;
- a separate instrument that would include the same conditions as the embedded derivative would meet the definition of a derivative;
- the hybrid instrument is not itself measured at fair value through profit or loss.

It is possible to **derecognize a financial asset** in order to raise funds by using this asset as a guarantee or as a first source of cash flow to reimburse the funds. In principle, derecognition is possible once the asset is transferred unconditionally to an unrelated third party including all the risks and rewards of this instrument.

Derecognizing a financial liability is compulsory if and only if the obligation is discharged (cancelled or expired).

A **gain (or a loss)** on a financial asset or a financial liability **measured at fair value** through profit or loss must be recognized through profit or loss except in any one of the following cases (assets or liabilities):

- hedging relationships (the gain or loss is then recognized in the annual profit);
- use of the alternative method (the gain or loss is then recognized in OCI);
- the variations in fair value related to the credit risk are recognized in OCI.

A **gain (or a loss)** on an asset or a financial liability **measured at amortized cost** (excluding hedging relationships) must be recognized through profit or loss when:

- the financial asset is derecognized, depreciated, reclassified or modified via the amortization procedure;
- the financial liability is derecognized or modified through the amortization process.

Hedge accounting may only be used if the following criteria are met:

- the hedging relationship consists only of eligible hedging instruments and eligible hedged items;
- there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge;
- the hedging relationship meets all of the following hedge effectiveness requirements:
  - ✓ there is an economic relationship between the hedged item and the hedging instrument;
  - ✓ the effect of credit risk does not dominate the value changes that result from that economic relationship;
  - ✓ the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item (as an imbalance could lead to hedge ineffectiveness).

In the event that an entity recognizes financial assets according to the **settlement date method**, no changes are recognized in the fair value of the asset to be received occurring between the trade date and the settlement date if the asset is measured at amortized cost (excluding impairment losses). For assets measured at fair value, changes are recognized through profit or loss or in OCI (same treatment as when initially recognized).