Overview of Philippine Financial Reporting Standards 9 (PFRS 9)

I. Classification and measurement

The classification determines how financial assets are accounted for in financial statements and how they are measured on an ongoing basis.

The measurement categories in which financial assets shall be classified under PFRS 9 are as follows:

1. Debt instruments at amortized cost
2. Debt instruments at fair value through other comprehensive income (FVOCI) with cumulative gains and losses reclassified to profit or loss upon derecognition
3. Debt instruments, derivatives and equity instruments at fair value through profit or loss (FVTPL)
4. Equity instruments designated as measured at FVOCI with gains and losses remaining in other comprehensive income (OCI), i.e., without recycling

The classification is based on both business model for managing the financial assets and the contractual cash flow characteristics of the financial asset. The process for determining the classification and measurement of financial assets is illustrated below:
A. Debt instruments

Debt instruments are classified and measured either at amortized cost or at fair value depending on the (a) the contractual cash flow characteristics of the financial asset and (b) the entity’s’ business model for managing financial assets.

**Contractual Cash Flows Characteristics Test**

The financial asset is assessed whether the contractual cash flows are solely payments of principal and interest (SPPI). Only financial assets with such cash flows are eligible for amortized cost or fair value through other comprehensive income measurement depending on the business model in which the asset is held. For contractual cash flows to be SPPI, they must include returns consistent with a basic lending arrangement.

**Business Model Test**

A business model refers to how an entity manages its financial assets in order to generate cash flows – (1) by collecting contractual cash flows (i.e. interest on deposits and coupon payments on bonds and other fixed income securities), (2) selling financial assets or (3) both. Depending on the characteristics of the contractual cash flows of the financial asset,

- Financial assets at amortized cost are held in a business model whose objective is to hold assets in order to collect contractual cash flows.
- 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.
- Financial assets that are not held in one of the two business models mentioned above are measured at fair value through profit or loss. Financial assets that are held for trading and those managed on a fair value basis are also included in this category.

B. Equity Instruments

On the other hand, equity securities will be classified at either fair value through profit or loss (FVTPL) or irrevocably designated at initial recognition at fair value through other comprehensive income (FVOCI). As such, all equity securities shall be measured at fair value. Cost may be used as proxy for fair value only in limited circumstances.

C. Derivatives

Derivatives will be classified and measured at fair value through profit or loss with fair value changes recognized in profit or loss.
D. Reclassification

Reclassification will be required only when an entity’s business model objective for its financial assets changes, which is expected to be very infrequent. It is prohibited in all other circumstances. If the reclassification is appropriate, it must be done prospectively from the reclassification date which is defined as the first day of the first reporting period following the change in business model.

II. Impairment

PFRS 9 introduces a new impairment model based on expected losses rather than incurred losses under PAS 39. Also, PFRS 9’s impairment requirements apply to the following financial assets:

1. Debt instruments measured at amortized cost
2. Debt instruments measured at FVOCI

Investments in equity instruments are outside the scope of the impairment requirements as they are measured at fair value.

The key changes from PAS 39 impairment requirements are illustrated below:

<table>
<thead>
<tr>
<th></th>
<th>PAS 39 “Incurred Credit Loss” model</th>
<th>PFRS 9 “Expected Credit Loss” model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timing of recognition of credit losses</td>
<td>Delayed recognition</td>
<td>Earlier recognition</td>
</tr>
<tr>
<td>Treatment of future losses</td>
<td>Recognition is prohibited</td>
<td>Recognition is required</td>
</tr>
<tr>
<td>Impairment trigger</td>
<td>Objective evidence or loss event</td>
<td>No trigger event to recognize allowance</td>
</tr>
<tr>
<td>Information used to estimate credit losses</td>
<td>Past events and current conditions</td>
<td>Past events, current conditions and forecast information</td>
</tr>
<tr>
<td>Application to financial asset types</td>
<td>Different model for amortized cost and FVOCI assets</td>
<td>Single model for amortized cost and FVOCI assets</td>
</tr>
</tbody>
</table>
Under the expected credit loss (ECL) model, impairment of financial assets is recognized in stages:

1. **Stage 1**—as soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognized 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 (i.e. without deduction for expected credit losses).

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

3. **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 amortized cost (i.e. the gross carrying amount less the loss allowance). Financial assets in this stage will generally be assessed individually. Lifetime expected credit losses are recognized on these financial assets.

### III. Hedge Accounting

The application of hedge accounting requirements under PFRS9 is optional. If certain eligibility and qualification criteria are met, hedge accounting can allow an entity to reflect its risk management activities in the financial statements by matching gains or losses on hedging instruments (e.g. derivatives) with losses or gains in the risk exposures they hedge (e.g. foreign exchange risk).

References:

- EY: Classification of financial instruments under IFRS9 (May 2015)
- IASB: IFRS9 Financial Instruments Project Summary (July 2014)
- Deloitte: IFRS 9: Financial Instruments – high level summary
- IFRS.org: IFRS 9 Financial Instruments