INTRODUCTION

The Mazars Insight series on IFRS aim at helping preparers, users and auditors of financial statements develop their theoretical and practical understanding of IFRSs. Our objective is to provide our readers, whether beginners or experts, with useful tools which provide clarity and insight on the challenging issues that may be encountered when applying IFRSs. Concepts are explained in a pedagogical way and illustrated by numerous practical examples.

This IFRS Insight addresses the accounting for financial instruments under IFRS. It draws on several relevant IFRS standards to tackle, in one manual, the entire range of challenges related to financial instruments among which: recognition and derecognition, classification and measurement, impairment for credit risk, derivatives and hedging, and related disclosures. It includes all the new requirements introduced by IFRS 9 and the related amendments to other standards such as IFRS 7.

After a two-pager providing an overview of IFRS requirements for financial instruments in 10 key points, a table of content shows the list of chapters. Each chapter starts with a detailed table of content to direct readers straight to the topic they are searching for. Many cross references have been inserted for improved reading experience. We draw specific attention to chapter 2 which comprises the definitions and the list of abbreviations and acronyms used in this manual.

Our special thanks are addressed to the international team of authors who contributed to this manual: Egle Mockaityte, Florence Michel, Heike Hartenberger, Mohamed Taghia and Nicolas Millot. Additional thanks go to Isabelle Grauer-Gaynor, Marie Fossat and Marion Platevoet for their precious help in finalising this publication.

Vincent Guillard
IFRS Lead Partner for Financial Instruments
10 KEY POINTS TO REMEMBER

1. Scope
The accounting treatment of financial instruments under IFRS is defined by several standards. IFRS 9 – Financial Instruments provides requirements for recognition and derecognition, classification, measurement (including impairment) and hedge accounting. IAS 32 – Financial Instruments: Presentation provides principles for distinguishing issued debt and equity instruments as well as requirements for offsetting financial assets and financial liabilities. IFRS 7 – Financial Instruments: Disclosures deals with most of the disclosure requirements, and IFRS 13 – Fair Value Measurement provides guidance on fair value measurement and related disclosure requirements. Each of these standards has specific scope exclusions, even for items that meet the definition of financial instruments. (see chapter 1)

2. Initial recognition
All financial instruments are initially recognised when the entity becomes party to the contract. Financial assets or liabilities are initially measured at their fair value plus or minus transaction costs, except financial instruments classified at FV-PL for which transaction costs are directly expensed into profit or loss. However, trade receivables are initially measured at their transaction price if they do not contain a significant financing component in accordance with IFRS 15. When the transaction price differs from the initial fair value of that financial instrument, a so-called “day one gain or loss” may need to be recognised upon initial recognition in profit or loss. (see chapter 6)

3. Classification of financial assets
Financial assets whose contractual cash flows are Solely Payments of Principal and Interest (the SPPI test) will be classified in accordance with the entity’s business model for managing the asset: Amortised Cost if they are subject to a Hold-To-Collect business model, FV-OCI if they are held within a Hold-To-Collect-and-Sell business model, or FV-PL in any other situation. Financial assets that do not pass the SPPI test (e.g. derivatives and equity instruments) must be classified in the FV-PL category, except for some equity instruments which the entity may irrevocably classify in FV-OCINR.

Subsequent reclassifications are limited to SPPI financial assets, upon a change in the entity’s business model and are thus expected to be very infrequent.

Subject to specific conditions (e.g. when a situation of an accounting mismatch would otherwise arise), an entity may irrevocably classify any financial asset as measured at FV-PL upon initial recognition. (see chapter 7)

4. Impairment for expected credit losses
Entities must recognise an allowance for expected credit losses for all financial assets classified in the Amortised Cost or FV-OCI category, as well as for most loan commitments and financial guarantees issued. Upon initial recognition of the instrument, the loss allowance is equal to the credit losses that the entity expects as a result from default events occurring within the next 12 months (12MECL). This amount is updated at each reporting date. When a Significant Increase in the Credit Risk (SICR) of the asset is identified, the loss allowance must be measured at an amount equal to the credit losses that the entity expects to occur over the full remaining life of the asset (LTECL).

Purchased or originated credit-impaired (POCI) assets (i.e. assets with existing incurred credit losses upon initial recognition) follow a separate impairment and revenue recognition model.
A simplified expected credit loss impairment approach is mandatory for short term trade receivables and contract assets, and optional for other trade receivables and contract assets, and lease receivables. (see chapter 9).

5. Classification of financial liabilities
Most financial liabilities are classified in the Amortised Cost category unless they are held for trading, or meet the conditions for a voluntarily classification in the FV-PL category upon their initial recognition. (see chapter 8)

6. Debt vs. Equity
Financial instruments issued that are in the scope of IAS 32 must be analysed to determine whether they meet the definition of an equity instrument or that of a financial liability. An instrument is generally classified as a financial liability if it requires the entity either to deliver cash or another financial asset, or to deliver a variable number of its own equity instruments. A derivative may qualify as an equity instrument if it will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of own equity instruments. Compound instruments contain both a liability and an equity component which must be accounted for separately.

7. Embedded derivatives
Derivative instruments may be either stand-alone contracts, or a feature embedded in a financial liability host contract or a non-financial host contract. Embedded derivatives must be bifurcated and accounted for separately as a stand-alone derivative if they are not economically closely related to their host contract. (see chapter 13)

8. Hedge accounting
Under IAS 39 and IFRS 9, most derivatives are by default measured at FV-PL whereas non-derivative financial assets and financial liabilities are often measured at amortised cost or FV-OCI. This situation may trigger accounting mismatches in profit or loss despite a proper economic offset between the hedging derivative and the hedged exposure. To better reflect the hedging strategy of the entity, IFRS 9 provides specific and optional accounting treatments for hedging relationships. The accounting impact depends on the nature of the hedging relationship (fair value hedge, cash flow hedge or net investment hedge). Hedge accounting is subject to eligibility, effectiveness and documentation-related conditions. (see chapter 14)

9. Derecognition
A financial asset is derecognised when and only when the contractual rights to the cash flows expire, or when the asset is transferred and this transfer meets the derecognition requirements. This test relies mainly on two criteria: the transfer of the contractual rights to the cash flows, and the transfer of the risks and rewards of ownership of the financial asset.

A financial liability is removed from the statement of financial position when it is extinguished. An exchange or modification of debt instruments, between an existing lender and borrower, is considered as an extinguishment of the original instrument if the terms of the original and the “new” instrument are substantially different.

10. Disclosures on financial instruments
The disclosure requirements aim at enabling the users to assess the significance of financial instruments for the entity, the nature and extent of risks arising from them, and how the entity manages those risks. (see chapter 16)
MAZARS INSIGHTS 
ON FINANCIAL INSTRUMENTS

▸ CHAPTER 1: Scope of standards applicable to financial instruments ............................................05
▸ CHAPTER 2: Definitions, acronyms and abbreviations used.................................................................23
▸ CHAPTER 4: Amortised cost..................................................................................................................35
▸ CHAPTER 6: Recognition and Initial measurement ...............................................................................51
▸ CHAPTER 7: Classification of financial assets .....................................................................................65
▸ CHAPTER 8: Classification of financial liabilities................................................................................105
▸ CHAPTER 9: Subsequent measurement of financial instruments
  (including impairment)............................................................................................................................117
▸ CHAPTER 13: Derivatives and embedded derivatives ..........................................................................197
▸ CHAPTER 14: Hedge accounting under IFRS 9 ...............................................................................235
▸ CHAPTER 16: Disclosures about financial instruments.......................................................................287
CHAPTER 6
RECOGNITION AND INITIAL MEASUREMENT
## TABLE OF CONTENTS

6.1. Introduction .............................................................................................................. 54

6.2. Initial recognition of financial instruments .......................................................... 54
   6.2.1. General requirements ......................................................................................... 54
   6.2.1.1. Date of initial recognition ........................................................................... 54
   6.2.1.2. Being a party to contractual provisions ..................................................... 54
   6.2.1.3. Contracts excluded from the scope of IFRS 9 .............................................. 54
   6.2.1.4. Illustrative examples .................................................................................. 55
   6.2.1.5. What if the purchased asset cannot be derecognised by the party selling it? 55
   6.2.1.6. Situations where the entity acts as an agent on behalf of another party ....... 55
   6.2.2. Regular way transactions: accounting policy election between accounting for financial assets on the trade date or on the settlement date .......................................................... 56
   6.2.2.1. Overview .................................................................................................... 56
   6.2.2.2. Definition of regular way contracts ........................................................... 56
   6.2.2.3. Accounting for regular way transactions .................................................... 57
   6.2.2.4. Accounting for transactions that are not regular way transactions .......... 58
   6.2.2.5. What about financial liabilities? ................................................................. 58

6.3. Measurement of financial instruments upon their initial recognition .................... 58
   6.3.1. General requirements ....................................................................................... 58
   6.3.2. Situations where fair value equals transaction price ......................................... 59
   6.3.3. Situations where fair value is different from transaction price ......................... 60
       6.3.3.1. Examples .................................................................................................. 60
       6.3.3.2. Accounting for the difference between the initial fair value and the transaction price (“Day one P&L”) ............................................................... 60
           6.3.3.2.1. On initial recognition date ................................................................. 60
           6.3.3.2.2. Subsequent accounting of deferred day one P&L ......................... 61
   6.3.4. Figure summarising the general approach ........................................................ 62
   6.3.5. Transaction costs ............................................................................................. 62
   6.3.6. Specific cases .................................................................................................. 63
       6.3.6.1. Assets and liabilities arising from loan commitments that are not in the scope of IFRS 9 ...... 63
       6.3.6.2. Initial recognition of financial guarantees issued .................................. 64
       6.3.6.3. Financial instruments acquired via a business combination or as part of a portfolio that does not constitute a business ................................................................. 64
6.1. Introduction

Recognising a financial instrument means including it in the statement of financial position. The initial recognition date is the date on which the financial instrument is included in the statement of financial position for the first time.

This section first explains on which date financial assets should initially be recognised, and then describes the amount at which this instrument should be measured on the date of its initial recognition.

Upon initial recognition, a financial asset must be classified in accordance with the requirements presented in chapter 7, and financial liabilities in accordance with the requirements presented in chapter 8.

Derecognition is the reverse of the recognition and refers to the date on which a financial instrument must be removed from the statement of financial position. Derecognition requirements are presented in chapters 10 and 11.

6.2. Initial recognition of financial instruments

6.2.1. General requirements

6.2.1.1. Date of initial recognition

Financial instruments are recognised on the balance sheet when the entity becomes party to the contractual provisions of the instrument (IFRS 9.3.1.1).

There may be a lag of several days between the “trade date” and the “settlement date”. IFRS 9 allows for an accounting policy election consisting in considering that the “entity becomes party to a contract” either on the trade date or on the settlement date (see section 6.2.2).

6.2.1.2. Being a party to contractual provisions

The standard does not require a particular form of contract (e.g. written, oral). All legally binding declarations relating to the offer and the acceptance of that offer are taken into account for the purposes of recognition.

Planned future transactions never require recognition (IFRS 9.B3.1.2(e)), no matter how likely they are. If the entity is not yet party to a contract, the likelihood of it concluding a contract in the future is irrelevant.

6.2.1.3. Contracts excluded from the scope of IFRS 9

Some contracts, although meeting the definition of a financial asset or of a financial liability in IAS 32 (see chapter 2), are excluded from the scope of IFRS 9. These include most loan commitments, leases, insurance contracts and or some contracts to buy or sell a non-financial item that are qualified as “own use contracts”, etc. (see chapter 1). These contracts are initially recognised and measured applying the requirements set out in the relevant applicable standards, if any.
**6.2.1.4. Illustrative examples**

Examples of how to apply the recognition principles set out in section 6.2.1.1 are provided in IFRS 9.

**Example 6.1**

Unconditional receivables and payables are recognised when the entity becomes a party to the contract and, as a result, has a legal right to receive or a legal obligation to pay cash (IFRS 9.B3.1.2(a)).

**Example 6.2**

Firm commitments to purchase or sell goods or services are generally not recognised as assets until at least one of the parties has performed under the agreement, e.g., until the goods have been delivered or the services rendered. If a firm commitment to purchase or sell a non-financial item (such as commodities) can be settled net in cash or with another financial instrument, it falls within the scope of IFRS 9 (see chapter 1) and is recognised as an asset or a liability on the commitment date for its net fair value.

**Example 6.3**

Forward contracts that are within the scope of IFRS 9 are recognised as assets or liabilities on the commitment date. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero (the contract balances out) (IFRS 9.B3.1.2(c)).

**Example 6.4**

Option contracts that are within the scope of IFRS 9 (see chapter 1) are recognised as assets or liabilities when the holder or writer becomes a party to the contract (IFRS 9.B3.1.2(d)).

**6.2.1.5. What if the purchased asset cannot be derecognised by the party selling it?**

IFRS 9 prohibits an entity from recognising a purchased financial asset if its transfer does not qualify for derecognition from the point of view of the seller (IFRS 9.B3.1.1). In such case the buyer still has to account for the cash outflow (or other consideration transferred to the seller) by recognising a receivable from the seller (IFRS 9.B3.2.15).

**6.2.1.6. Situations where the entity acts as an agent on behalf of another party**

When an entity acts as an intermediary in a transaction involving a financial instrument, an analysis must be performed to determine whether the entity is to be considered as acting as an agent or as a principal. An agent may buy a financial instrument in the name and on behalf of another entity. An agent is not considered as an actual party to the contract and will not account for the instrument on its balance sheet. Only transactions where the entity is a party to the contract as a principal will have to be recognised on the entity’s balance sheet.
This question frequently arises for brokerage and similar activities. If the broker is considered as acting as a principal, he will account for two back-to-back transactions on its balance sheet. However, if he is considered as acting as an agent, he will solely recognise its commission in profit or loss. IFRS 15 provides some guidance in this regard, but such analysis often requires the exercise of judgment. A legal opinion may also be necessary to support the agent vs. principal analysis applied to such transactions.

6.2.2. Regular way transactions: accounting policy election between accounting for financial assets on the trade date or on the settlement date

6.2.2.1. Overview

There is often a lapse of time between the moment the entity commits to buy or sell financial assets at a fixed price and the date when the effective delivery of these assets takes place (which, in general, corresponds to the date on which the cash flow / settlement takes place). An example is the purchase of a security where the parties agree on a price on a given day, but the delivery of the security and the payment of the agreed price occurs two business days later. Such a fixed price commitment to buy / sell a financial asset meets the definition of a derivative (see chapter 13). However, because of their short duration, commitments that are qualified as “regular way purchases” (see section 6.2.2.2) are not recognised as derivatives (IFRS 9.BA.4). IFRS 9 contains a specific accounting policy election for such transactions (see section 6.2.2.3).

Asset purchases that do not qualify as “regular way purchases” are subject to different rules, which are presented in section 6.2.2.4.

6.2.2.2. Definition of regular way contracts

Regular way purchases or sales are defined in IFRS 9 Appendix A as purchases or sales of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

In its implementation guidance (IFRS 9.IG.B.29), IFRS 9 gives an example of a forward contract to buy ordinary shares traded in an active public market. That contract does not qualify as a regular way purchase because the maturity of the forward is 2 months, whereas a regular way delivery of these shares in that particular market usually takes only three business days. Based on IFRS 9.IG.B.29, the conclusion would have been the same if the settlement date of the transaction were six days later than the trade date.

When a financial asset is traded in more than one active market and the settlement duration differs across these active markets, the entity should refer to the time frame that applies in the market in which the purchase actually takes place in identifying whether a commitment to buy that financial contract is a regular way purchase (IFRS 9.IG.B.30).

It is important to note that a regular way contract requires the delivery of an asset. Consequently, if the contract allows or requires a net settlement, it cannot be considered as a regular way contract and should rather be accounted for as a derivative instrument (IFRS 9.B3.1.4).
6.2.2.3. Accounting for regular way transactions

An entity may elect (IFRS 9.B3.1.3) to use either trade date accounting (IFRS 9.B3.1.5) or settlement date accounting (IFRS 9.B3.1.6) to recognise regular way purchases or sales of securities, currency and other financial assets.

The trade date is the date on which an entity commits to purchase / sell an asset (IFRS 9.B3.1.5) and the settlement date is the date on which an asset is delivered to the entity (IFRS 9.B3.1.6).

The election is made separately for each category of financial asset (e.g. financial assets measured at amortised cost, financial assets measured at fair value though other comprehensive income with subsequent recycling to profit or loss, equity instruments that are optionally designated as measured at fair value through other comprehensive income...) and is applied consistently to this category (IFRS 9.B3.1.3). The election made for a given financial asset category applies to both purchase and sale transactions.

If an entity elects to apply trade date accounting to a financial asset (IFRS 9.B3.1.5):

— the asset to be received upon settlement is recognised in the balance sheet on the trade date, against a payable on the liability side; and

— any change in the fair value of the asset between the trade date and the settlement date is accounted for in line with the general principles of the asset’s subsequent measurement method. This means that, for assets that are measured at fair value through profit or loss, the change in fair value is recognised in profit or loss. For assets measured at fair value through other comprehensive income, the change in value is recognised in other comprehensive income. The change in fair value is not recognised for assets measured at amortised cost.

If the entity elects to apply settlement date accounting (IFRS 9.B3.1.6):

— the asset is only recognised in the balance sheet on the settlement date (i.e. when it is effectively received by the entity) against a cash outflow;

— any change in the fair value during the period between the trade date and the settlement date is accounted for in the same way as the entity would account for the acquired asset. For acquired assets that are measured at fair value through profit or loss, the change in fair value is recognised in profit or loss, and for assets measured at fair value through other comprehensive income, the change in fair value is recognised in other comprehensive income. The changes in fair value is not recognised for assets measured at amortised cost. This means that when an entity uses settlement date accounting for an asset that is subsequently measured at amortised cost, the asset is initially recognised on the settlement date for an amount equal to its fair value on the trade date (IFRS 9.5.1.2 and IFRS 9.IG.D.2.1).

For the purpose of impairment requirements, an entity should always consider the trade date of the transaction as the initial recognition date (IFRS 9.5.7.4).

In the end, this accounting policy election has an impact on the presentation of the statement of financial position (with the total balance sheet amount being “increased” earlier when trade date accounting is used), but has no impact on the statement of comprehensive income.
6.2.2.4. Accounting for transactions that are not regular way transactions

A contract for the sale or purchase of a financial asset is not a regular way contract if, for example:

- the terms permit or require net settlement, rather than the parties delivering the asset and the payment respectively; or
- the delay between the contractual trade date and the settlement date exceeds the customarily practice according to the established market practice.

Such contracts are accounted for as a derivative in the period between the trade date and the settlement date and are thus recognised at the trade date (IFRS 9.B3.1.4). This means that:

- this derivative is to be measured at fair value and that its change in value must be recognised through profit or loss during the period between the trade date and the settlement date; and
- it is to be derecognised at its fair value on the date of delivery of the asset resulting from the purchase commitment against:
  - a cash outflow corresponding to the price stated in the purchase contract; and
  - an initial recognition of the purchased financial asset at its fair value.

6.2.2.5. What about financial liabilities?

The implementation guidance of IFRS 9 (IFRS 9.IG.B.32) specifies that:

- IFRS 9 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of financial liabilities;
- the general recognition requirements in IFRS 9.3.1.1 apply (i.e. financial liabilities are recognised on the date when the entity becomes a party to the contract);
- financial liabilities are generally not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of IFRS 9.

As a result, section 6.2.2 must not be applied upon the initial recognition of financial liabilities.

6.3. Measurement of financial instruments upon their initial recognition

6.3.1. General requirements

The amount at which financial instruments are measured at their initial recognition depends on their nature and measurement category (see chapter 7 for classification of financial assets and chapter 8 for classification of financial liabilities):

- financial assets and financial liabilities that are subsequently measured at fair value through profit or loss (either optionally designated or mandatorily measured in such a way) are measured at their fair value on their initial recognition date (see chapter 3 for more information on how fair value is determined). The transaction costs directly attributable to the acquisition of such financial assets or to the issue of such financial liabilities are immediately expensed to profit or loss (IFRS 9.5.1.1);
— trade receivables that do not contain a significant financing component (as defined by IFRS 15) are initially measured at their transaction price as defined in IFRS 15 (IFRS 9.5.1.3). This means that short term trade receivables (i.e. with initial maturity of less than 12 months) will generally be recognised for the amount indicated in the invoice;

— all other financial assets and financial liabilities are initially measured at their fair value plus or minus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability (IFRS 9.5.1.1).

Assets that are subsequently measured at amortised cost, and for which an accounting policy choice has been made to initially recognise them on their settlement date, are recognised initially at their fair value determined on the trade date (rather than at their fair value on settlement date) (IFRS 9.5.1.2).

Including transaction costs in the initial measurement means (IFRS 9.I.G.E.1.1):

— for financial assets, that the transaction costs are added to the fair value at initial recognition;
— for financial liabilities, that the transaction costs are deducted from the fair value at initial recognition.

The subsequent recognition pattern of these costs depends on the instrument’s measurement category (IFRS 9.I.G.E.1.1):

— for financial assets and financial liabilities that are measured at amortised cost, as well as for financial assets that are measured at fair value though other comprehensive income with subsequent recycling to profit or loss, transaction costs are subsequently included in the calculation of amortised cost using the effective interest method. As a result, they are amortised through profit or loss over the life of the instrument (see chapter 4);

— for equity financial instruments that are measured at fair value through other comprehensive income without subsequent recycling to profit or loss in accordance with IFRS 9.5.7.5 (see sections 7.3.1 and 7.3.2), transaction costs are recognised in other comprehensive income as part of a change in fair value at the next remeasurement date. As the realised gains or losses for this category are not subsequently transferred to profit or loss, any transaction costs incurred to purchase these instruments will never impact the profit or loss of the entity.

### 6.3.2. Situations where fair value equals transaction price

The fair value of a financial instrument at initial recognition is normally the transaction price, i.e. the fair value of the consideration given / received (IFRS 9.B5.1.1). IFRS 9.B5.1.2A further states that the best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price.

However, if part of the consideration given or received is for something other than the financial instrument, it may indicate that the transaction price may be different from the fair value, and that therefore the fair value of the financial instrument must be measured (see section 6.3.3).
6.3.3. Situations where fair value is different from transaction price

6.3.3.1. Examples

One example of where the initial fair value may be different from the transaction price is off-market interest rate long-term loans (e.g. loans bearing a 5% rate whereas the prevailing market rate for similar loans is 8%), or long-term interest-free loans. Such situations may arise between entities under common control, or when the loan is one component of a larger transaction. For these loans, a valuation technique should be used (such as discounting the contractual cash flows at a market interest rate for a similar financial instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating) to establish their initial fair value. Any difference between the transaction price and this initial fair value must follow the accounting treatment described in the following section, except for trade receivables initially recognised at their transaction price.

“Day one P&L” are typically more common in financial institution than in corporate treasury.

6.3.3.2. Accounting for the difference between the initial fair value and the transaction price (“Day one P&L”)

6.3.3.2.1. On initial recognition date

The difference between the transaction price and the initial fair value of a financial asset or a financial liability is generally referred to as “day one P&L” or “day one profit or loss”. This day one P&L may either be recognised in profit or loss immediately or deferred. The accounting treatment is not an accounting policy choice, it depends on whether the inputs used to estimate the instrument’s initial fair value are observable or not (IFRS 9.B5.1.2A). The two situations are presented below:

— **Situation 1**: the instrument’s valuation technique uses only data from observable markets (e.g. fair value is evidenced by a quoted price in an active market for an identical asset or is based on a valuation technique that uses only data from observable markets, i.e. Level 1 inputs):
  > the instrument is recognised initially at its initial fair value, plus (if applicable to the instrument’s measurement category, as explained in section 6.3.1) transaction costs;
  > the difference between the fair value at initial recognition and the transaction price is recognised immediately as a gain or loss (IFRS 9.B5.1.2A).

— **Situation 2**: in any other situation (i.e. the instrument’s valuation technique uses one or more non-observable inputs):
  > the asset’s initial fair value is adjusted to defer the difference between the fair value at initial recognition and the transaction price;
  > this means in practice that the instrument is recognised initially at its transaction price, plus (if applicable to the instrument’s measurement category, as explained in section 6.3.1) transaction costs;
  > for subsequent accounting (see section 6.3.3.2.2) and disclosure purposes (see chapter 16), the amount of deferred day one P&L is identified separately from the instrument’s initial fair value.
To our knowledge, most entities confronted with the deferred day one P&L issue (in particular financial institutions) use separate accounts to distinguish the fair value of the instrument from the deferred day one P&L reserve. This facilitates the subsequent monitoring of the deferred day one P&L.

Consider the following example:

- an asset is purchased at CU 100 with no transaction costs;
- its initial fair value, determined based on a valuation technique using significant level 3 inputs, is CU 103;
- the day one P&L amounts to CU 3 (=103 – 100). This amount is deferred and monitored separately from the future change in value of the instrument.

The rationale behind the day one P&L accounting rule explained just above is that only the most “reliable” (i.e. fully observable) valuations may rebut the presumption that the transaction price is the best evidence of fair value (see section 6.3.2) and therefore imply a profit and loss impact.

Please refer to chapter 3 for more information on valuation techniques and observability of inputs.

6.3.3.2.2. Subsequent accounting of deferred day one P&L

The deferred day one P&L (difference between the transaction price and the initial fair value) is recognised as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

Entities must exercise their judgment to identify whether there has been a “change in factors (including time)” that would justify partial or full recognition in profit or loss of the deferred day one P&L reserve.

In practice, entities (and in particular financial institutions) may amortise the deferred day one P&L into profit or loss on a straight-line basis over the lifetime of the instrument. This accounting treatment may be an appropriate method in some cases where the passage of time is the driving factor, but it may not be appropriate in others.
6.3.4. Figure summarising the general approach

The following figure summarises the general approach of day one P&L accounting:

Figure 6.1

6.3.5. Transaction costs

Appendix A of IFRS 9 defines transaction costs as “Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability”. An incremental cost is one that would not have been incurred, hadn’t the entity acquired, issued or disposed of the financial instrument.

Transaction costs:

— include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties (IFRS 9.B5.4.8).

— but they do not include:

  > debt premiums or discounts, financing costs or internal administrative or holding costs (IFRS 9.B5.4.8); or

  > transaction costs expected to be incurred on transfer or disposal of a financial instrument (IFRS 9.IG.E.1.1).
6.3.6. Specific cases

6.3.6.1. Assets and liabilities arising from loan commitments that are not in the scope of IFRS 9

As per the scope requirements in IFRS 9.2.1(g) (see chapter 1), most loan commitments issued are out of the scope of IFRS 9 (and in particular those that are not optionally designated by the entity as measured at fair value through profit or loss), i.e. they are not accounted for as derivatives. They only follow the impairment guidance of IFRS 9 until they are drawn down.

Once such loan commitments are drawn down, IFRS 9 is not very clear on the initial measurement of assets resulting from these commitments.

Example 6.5

A bank issued a commitment to lend to the company at 5%.

6 months later, when the entity draws down the loan, the applicable market rate would have been 7% (since both the interest free rate and the entity’s credit spread have increased during that-time).

Although the bank has lent CU 100, the fair value of this loan on the day the funds are transferred is only CU 90, because of the higher discount rate (x+2% instead of x%) used to determine the fair value of the loan.

Assuming there are no transaction costs, the question is whether the loan should be recognised at CU 100 (its transaction price and its fair value at the date of the loan commitment) or CU 90 (its fair value at the date of drawdown).

In our view, several interpretations are possible:

— **Approach 1**: if we apply the general requirements in IFRS 9.5.1.1 to initially measure financial assets at their fair value, it would seem reasonable to account for the loan at its fair value of CU 90;

— **Approach 2**: however, the basis for conclusions of IFRS 9.BCZ.2.3 explain that (a) the exclusion of loan commitments from the scope of IFRS 9 was supposed to simplify the accounting for these loan commitments and (b) that this scope exclusion is consistent with the measurement of the loan. Furthermore, IFRS 9.5.1.2 specifies that financial assets measured at amortised cost are to be measured at their fair value on trade date even when settlement date accounting is used. If we define trade date as the date the entity entered into a loan commitment, this would mean, in our example, that the loan must initially be measured at CU 100 and not CU 90.

To our knowledge, the second approach is the one frequently used in practice.
6.3.6.2. Initial recognition of financial guarantees issued

When financial guarantee contracts that fall within the scope of IFRS 9 are recognised in the financial statements of the issuer, this usually relates to situations in which the issuer is guaranteeing a debtor’s obligation to a third party (the guarantee holder) and is thus required to make specified payments if the debtor defaults on the obligation or fails to comply with specified terms of a debt instrument.

At initial recognition, financial guarantee contracts must be accounted for in accordance with the general principles at fair value. If a financial guarantee contract is issued to an unrelated party in a standalone arm’s length transaction, its fair value at inception is likely to equal the premium received (transaction price), unless there is evidence of the contrary (IFRS 9.B2.5(a)).

6.3.6.3. Financial instruments acquired via a business combination or as part of a portfolio that does not constitute a business

General recognition and measurement requirements apply to financial instruments acquired via a business combination or as part of a portfolio that does not constitute a business.

Indeed, for financial instruments acquired via a business combination the requirements in IFRS 3.18 are aligned with those in IFRS 9 regarding the fact that the acquirer of financial instruments must account for them at their fair value on acquisition date. The difficulties in practice may stem from the fact that the initial fair value must be assigned to each financial instrument acquired.

For financial instruments acquired as part of a portfolio that does not constitute a business, it may not be easy to allocate the global transaction price to individual instruments, when assessing whether a day one P&L must be recognised.

---

1 For further detail on this topic, please refer to IFRIC Update November 2017.