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A Digital Learning Platform for Generation Z: Passport to IFRS®

IFRS® Standard 9 Financial Instruments



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CASE STUDY - IFRS 9 FINANCIAL INSTRUMENTS

Introduction

Accounting for financial instruments is a complex and comprehensive issue. IFRS 9 sets the framework for the recognition, derecognition, and valuation of financial instruments. There are two income elements related to financial instruments. The first is income items such as interest and dividends arising from financial instruments. The second is the fair value differences of the financial instrument.

In this case, it is aimed to explain how the value of the financial instrument will be determined in the statement of financial position and how the value differences will be reported depending on the classification of financial instruments.

The Case Information

2020 has been a very successful year for River Company. The business had significantly increased its profitability in 2020. As a result of this financial performance, the cash flows of the business from its operations increased significantly. And that resulted in the business's cash and cash equivalents tripling and having a significant cash surplus in 2021. River Company management decided to use this surplus cash by investing in financial instruments. As a result of their evaluation, the management has decided to make an investment that will generate interest income with a part of the excess cash and an equity investment with the remaining part.

River Company purchased three different shares (Purple Company, Turquoise Company and Mandarin Company) from the stock market in March 2021. The total cost of the purchased shares is as follows.

Purple Company	CU25,600
Turquoise Company	CU68,800
Mandarin Company	CU47,300

River Company management classified these equity investments as Financial Asset at Fair Value Through Other Comprehensive Income (FAFVTOCI).

River Company also purchased some bonds of an entity from its initial public offering on 1 July 2021 for CU 96,139. The bond has a nominal value of CU 100,000 and a nominal interest rate of 9%. The interest payments are made semi-annually on June 30 and December 31. The bond provides 10% interest for the investors. River management has determined that the business model for this type of investments is to hold to earn interest income.

The following data are available on the value of River Company's investments at the end of 2021.

Purple Company	CU35,400
Turquoise Company	CU65,000
Mandarin Company	CU50,700
Bond value	CU92,000

In 2021, River Co earned CU4,807 interest on its bond investment and collected CU4,500 interest.

At the end of 2022, information on River Co investments is as follows.

Purple Company	CU38,400
Turquoise Company	CU67,500
Mandarin Company	CU40,700
Bond value	CU98,000

In 2022, River Company earned CU 9,661 interest on its bond investment and collected CU 9,000 interest. At the end of 2022, River management has decided that the business model for both investments has changed and that the new business model is a business model for these investments is to profit from trading on price changes. Therefore, they stated that all investments will now be reclassified as Financial Asset Measured at Fair value through profit or loss (FAFVTPL).

Discussion Questions

- a. How should River Company financial instrument investments be presented in the statement of financial position as of December 31, 2021? What should be reported about these investments in the profit and loss statement for 2021?
- b. Can River Company reclassify its financial instruments by the end of 2022?
- c. What should be the accounts and amounts to be reported in the 2022 financial statements?

SOLUTION OF CASE STUDY – IFRS 9 FINANCIAL INSTRUMENTS

- a. River management has decided to classify their share investments as Financial Asset at Fair Value Through Other Comprehensive Income (FAFVTOCI) in initial recognition. River management will report the change in the total value of their equity investment portfolios as part of their other comprehensive income.

River management, on the other hand, decides to keep its bond investments for the sole purpose of earning interest income. Therefore, these investments should be classified as financial assets valued at amortized cost. Equity and debt instrument investments will be shown in the statement of financial position dated 31 December 2021 and in the profit and loss statement for 2021 as follows.

31 December 2021	Carrying Value, CU	Fair Value, CU	Unrealized Gain (Loss), CU
Purple Company	25,600	35,400	9,800
Turquoise Company	68,800	65,000	(3,800)
Mandarin Company	47,300	50,700	3,400
Total			CU9,400

Dr. Financial Assets (FAFVTOCI)	9,400	
Cr. Unrealized Holding Gain (OCI)		9,400

A bond amortization table should be prepared in order to determine the interest income from the bond investment and the end-of-period bond value. The entity will periodically earn 5% on its bond investment and will charge interest of CU4500 at the end of each six months. Amounts are rounded in the table.

Periods	Beginning balance, CU	Interest Income, CU	Interest Receivable, CU	Ending Balance, CU
2021/2	96.139	4.807	4.500	96.446
2022/1	96.446	4.822	4.500	96.768
2022/2	96.768	4.838	4.500	97.107

Dr. Financial Assets (FAAC)	307	
Dr. Cash	4,500	
Cr. Interest Income		4,807

At the end of 2021, these investments will appear in the financial statements as follows.

River Company Statement of Financial Position as of 31.12.2021			
ASSETS		LIABILITIES	
Equity Investments	151,100		
Debt Investments	96,446	EQUITY	
		Unrealized Holding Gain	9,400
River Company Profit/Loss and Other Comprehensive Income Statement for the year 2021			
PROFIT/LOSS			
Interest Income	4,807		
OTHER COMPREHENSIVE INCOME			
Unrealized Holding Gain	9,400		

- b. River Management may change the classification of financial instruments subject to a change in business models. However, for equity instruments, it can be determined irreversibly as Financial Asset at Fair Value Through Other Comprehensive Income (FAFVTOCI) at the initial recognition.
- c. Equity instruments are irreversibly classified as Financial Asset at Fair Value Through Other Comprehensive Income (FAFVTOCI) and no change will be made to them. Thus, their values on 31 December 2022 will be as follows.

31 December 2021	Carrying Value, CU	Fair Value, CU	Unrealized Gain (Loss), CU
Purple Company	35,400	38,400	3,000
Turquoise Company	65,000	67,500	2,500
Mandarin Company	50,700	40,700	(10,000)
Total			CU(4,500)

Dr. Unrealized Holding Loss (OCI) 4,500
 Cr. Financial Assets (FAFVTOCI) 4,500

For bonds, the interest income and interest collection records for 30 June and 31 December should be made first.

30 June 2022

Dr. Financial Assets (FAAC) 322
 Dr. Cash 4,500
 Cr. Interest Income 4,822

31 December 2022

Dr. Financial Assets (FAAC) 338
 Dr. Cash 4,500
 Cr. Interest Income 4,838

After these entries, the carrying amount of the investment would be CU97,107. At the end of the year, the bond investment should also be reclassified. With the reclassification, the bond will be reported as Financial Asset Measured at Fair value through profit or loss (FAFVTPL). As a result of the reclassification, the value of the bond investment will be its fair value at 31 December 2022. And the valuation difference will be reported in profit and loss.

31 December 2022

Dr. Financial Assets (FAFVTPL)	98,000	
Cr. Financial Assets (FAAC)		97,107
Cr. Fair Value Gain		893

Financial investments will be as follows in the year-end financial statements.

River Company Statement of Financial Position as of 31.12.2022			
ASSETS		LIABILITIES	
Equity Investments	146,600		
Debt Investments	98,000	EQUITY	
		Unrealized Holding Gain	4,900
River Company Profit/Loss and Other Comprehensive Income Statement for the year 2022			
PROFIT/LOSS			
Interest Income	8,661		
Fair Value Gain	893		
OTHER COMPREHENSIVE INCOME			
Unrealized Holding Loss	(4,500)		