

## Navigating The Financial Instruments Labyrinth – Part 1: Debt Instruments and Equity Instruments from the Holder’s Perspective



## Is the accounting for financial instruments complex?

The accounting for financial instruments is known to be one of the most complex for the accountancy profession. This is because of the maze of accounting rules surrounding financial instruments, and one needs to be able to navigate through the various requirements to escape the labyrinth!



How does one navigate through the *labyrinth of accounting rules* within SFRS(I) 9 *Financial Instruments*, SFRS(I) 1-32 *Financial Instruments: Presentation* and SFRS(I) 7 *Financial Instruments: Disclosures*?

This is the first of a series of articles written to demystify and make sense of the requirements within the accounting standards for financial instruments. In this piece, I will reveal several keys to navigate the maze within SFRS(I) 9. The *labyrinth solutions* that I will share below are paragraphs within SFRS(I) 9, to guide you to an accounting resolution.

**As appetizer, let's consider the following statements. Which do you agree with?**

- I. Fair value gains/losses for debt instruments with changes in fair value recognised in other comprehensive income ("OCI") are recycled to P&L on derecognition.
- II. Fair value gains/losses for equity instruments with changes in fair value recognised in OCI are recycled to P&L on derecognition.
- III. Fair value gains/losses for financial liabilities designated at FVPL are recognised in OCI for changes in their own credit risk.
- IV. The 2009 financial crisis was the catalyst for IFRS 9.
- V. IAS 39's 'incurred loss' model was blamed by some for causing the 2009 financial crisis.

Fair value gains/losses for debt instruments with changes in fair value recognised in other comprehensive income (“OCI”) are recycled to P&L on derecognition.

Statement I – TRUE.

Labyrinth Solution: 4.1.2A => 5.7.10

Paragraph [4.1.2A](#) stipulates 2 conditions that must be met for a financial asset to be measured at Fair

Value through Other Comprehensive Income (“FVOCI”). One condition is that the financial asset gives rise on specific dates to cash flows that are **Solely Payments of Principal and Interest (“SPPI”)** on the principal amount outstanding, typically referenced as the **SPPI test**. Consequently, an equity instrument will never pass the **SPPI test**. A debt instrument on the other hand, depending on its contractual terms, could pass the **SPPI test**.

The term ‘debt instruments’ is not defined in the accounting standards. Investopedia states that debt instruments are any form of debt used to raise capital for businesses and governments. There are many types of debt instruments, but the most common are credit products, bonds or loans.

Paragraphs [5.7.10](#) stipulates that when a financial asset classified under paragraph [4.1.2A](#) is derecognised, the cumulative gain or loss previously recognised in OCI is reclassified from equity to profit or loss as a reclassification adjustment. In other words, the fair value gains/losses of debt instruments measured under FVOCI are recycled to profit or loss on derecognition.



## Investments in equity instruments

*Are fair value gains/losses for equity instruments with changes in fair value recognised in other comprehensive income (“OCI”) recycled to P&L on derecognition?*

Statement II – FALSE.

**Labyrinth Solution:** 4.1.4 => 5.7.5 => B5.7.1

As mentioned above, an equity instrument will never pass the SPPI test. However, paragraph 5.7.5 allows an entity to make an **irrevocable election** at initial recognition for an investment in an equity instrument to present in OCI subsequent changes in the fair value. This applies to equity instruments within the scope of SFRS(I) 9 that are not held for trading.

Unlike debt instruments classified under paragraph 4.1.2A, paragraph B5.7.1 requires that amounts presented in OCI be not subsequently transferred to profit or loss. It however allows an entity to transfer the cumulative gain or loss within equity.

An accurate statement in place of statement II would be:

*Fair value gains/losses for equity instruments under irrevocable election to present subsequent changes in fair value in OCI are **NOT** recycled to P&L on derecognition.*

### *Where does the confusion lie?*

Whilst Section 5.7 Gains and Losses of SFRS(I) 9 addresses the derecognition of debt instruments classified under FVOCI in paragraph 5.7.10, Section 5.7 does not address the derecognition of equity instruments under the **irrevocable election** classification. Nor does it make an explicit reference to paragraph B5.7.1.



## Impairment – Loss allowance for expected credit losses

SFRS(I) 9 addresses **Impairment** under *Section 5.5* and addresses **Gains and losses** under *Section 5.7*. From the get-go, it is important to understand these two concepts and how they work with each other.

*Section 5.5 Impairment* requires a loss allowance for expected credit losses on a financial asset that is classified in accordance with paragraphs [4.1.2](#) and [4.1.2A](#). This loss allowance, also referred to as impairment loss is to be recognised in profit or loss.

### *What is scoped out of Section 5.5 Impairment?*

Debt instruments classified under fair value through profit or loss (“FVPL”) and **ALL** equity instruments are **NOT** subjected to impairment under *Section 5.5*.

In more simple language, debt instruments classified under amortised cost (i.e. satisfies the conditions of paragraph [4.1.2](#)) and debt instruments classified under FVOCI (i.e. satisfies the conditions of paragraph [4.1.2A](#)) are subjected to expected credit losses assessment.

**ALL** other financial instruments are **NOT**.

It is note-worthy that all financial instruments measured at fair value are not subjected to impairment **EXCEPT** for debt instruments classified under FVOCI.



***How would debt instruments classified under FVOCI (“4.1.2A debt instrument”) be impaired when it is already measured at fair value on the balance sheet?***

**Labyrinth Solution: 5.5.2 => 5.7.10**

Paragraph 5.5.2 specifically requires debt instruments classified under FVOCI (“4.1.2A debt instruments”) to apply the impairment requirements of *Section 5.5*. However, this loss allowance shall be measured in OCI and shall not reduce the carrying amount of the financial asset in the statement of financial position.

In simple language, an impairment loss is expensed (debited) in profit or loss and credited to OCI. The carrying amount of the 4.1.2A debt instrument on the balance sheet remains at fair value.

Paragraph 5.7.10 further states that the fair value gain or loss of the 4.1.2A debt instrument is recognised in OCI, except for impairment gains or losses.

In simple language, 4.1.2A debt instrument is recognised at fair value on the balance sheet. Fair value changes is taken to OCI. Impairment loss recognised in profit or loss is credited to OCI and not to the carrying amount on the balance sheet, which is already at fair value.

## Closing Remarks

*What I had written above concerns financial assets from the holder’s perspective. And I have not forgotten about Statements III, IV and V. They are all true. I will dwell into financial liabilities and equity from the issuer’s perspective in my next article – Part 2 of this series.*

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