







- What is financial instrument?
 - Contract
 - Creates a financial asset of one entity; and a financial liability or equity instrument of another
 - Financial assets cash, receivables, equity instruments of other entities
 - Financial liabilities payables, issued debt





- Classifications of Financial Assets
 - Amortized Cost: SPPI test passed + business model is holdto-collect
 - FVOCI: SPPI test passed + business model is hold-tocollect-and-sell
 - FVPL: Default category if SPPI fails or held for trading

Overview and Classification

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 - FVPL: Default category if SPPI fails or held for trading

Where to look:

- Accounting policy notes
- Board/investment committee reports
- Risk management documents
- Credit policy documents



Overview and Classification

- SPPI Test (Solely Payments of Principal and Interest)
 - Cash flows only represent principal + interest (time value of money, credit risk)
 - Fails SPPI if includes:
 - Leverage features
 - Equity-linked returns
 - Non-standard clauses

Overview and Classification

- Practical Considerations
 - Preparers
 - Ensure documentation of business model and SPPI testing
 - Align classification with actual intent and usage
 - Auditors
 - Obtain management assessment of business model/SPPI
 - Watch for inconsistent classification vs disclosures



- Initial Recognition Principles
 - Recognize when entity becomes party to the contract
 - Indicators:
 - Legal rights/obligations exist (binding contract)
 - Entity has present rights to financial asset or obligation to financial liability
 - Recognition date is typically:
 - Trade date for regular way of purchases/sales
 - Contract signing date for loans or debt issuance

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- Ask legal or management "from what date are the parties legally bound?"
- If funds are already transferred before the signing, recognition may need to be earlier





- Initial Measurement
 - Initially at fair value
 - PLUS transactions costs if asset is not at FVPL
 - Fair value determination:
 - Quoted prices (active markets), or
 - Valuation techniques (DCF, comparables) if no market price

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For Bonds and Debt Securities:

- Brokerage fees and commissions
- Stamp duties
- Transfer taxes



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 - Quoted prices (active mark)
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For Loans Granted by a Bank or Entity:

- Legal fees for preparing the contract
- Credit evaluation fees
- Documentation and/or registration fees for collateral

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 - Initially at fair value
 - PLUS transactions costs if as
 - Fair value determination:
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 - Valuation techniques (DC price

For Shares in Private Companies:

- Due diligence fees
- Finder's fees
- Registration and filing fees

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 - Initially at fair value
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NOT transaction costs:

- Internal administrative costs (e.g., staff salaries)
- Advertising and promotion costs for securities



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 - Fair value determination:

- Sample sources for rates:
- Observable Market Rates
- Adjusted Risk-Free Rate
- Internal Historical Lending Rates

Valuation techniques (<u>DCF</u>, comparables) if no market price

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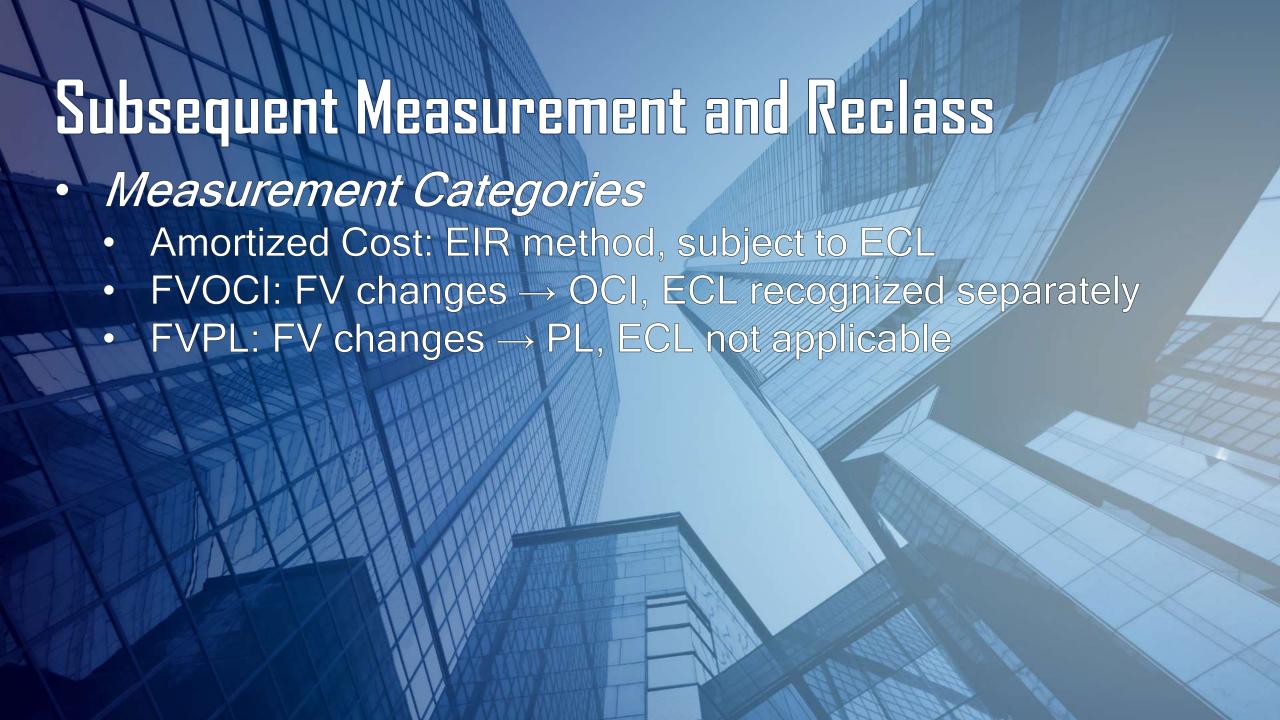
Practical Steps:

- 1. Start with Government Bond Yield (e.g., for a 5-year bond, the rate is 4.86%)
- 2. Add a Credit Spread based on borrower's creditworthiness (e.g., company is rated BBB with spread of 2.10%)
- 3. Include other adjustments (i.e., professional judgment) (e.g., 0.2%)
- 4. Calculate estimated rate (e.g., 7.16%)



- Practical Application
 - Preparers
 - Verify recognition date = contract date
 - Use appropriate FV method for unlisted instruments
 - Assess if transaction costs are correctly capitalized/expensed
 - Auditors
 - Review agreements, trade confirmations
 - Recompute fair value and check against market rates
 - Verify JEs, disclosures, and note consistency





Subsequent Measurement and Reclass

- Measurement Categories
 - Amortized Cost: EIR method, subject to ECL
 - FVOCI: FV changes → OCI, ECL recognized separately
 - FVPL: FV changes → PL, ECL not applicable

FV Hierarchy:

- Level 1 If traded in an *active market*, use **quoted prices** (e.g., Government bonds)
- Level 2 Quoted yields/prices for similar instruments (similar maturity, credit rating, and currency)
- Level 3 Unobservable/internal inputs (e.g., DCF using internally estimated credit spreads or rates)





- Reclassification Rules
 - Only allowed if business model changes
 - Apply prospectively from reclassification date
 - Reclassification date: first day of the year following the change in business model
 - SPPI test not redone unless asset is modified



- Reclassification Rules
 - Only allowed if business model changes
 - Apply prospective
 - Reclassification change in busine
 - SPPI test not rec

Steps to assess change in business model:

1) Review internal policies and strategies Ask management:

"Has the company recently updated its investment strategy or asset-liability management policy?"



- Reclassification Rules
 - Only allowed if business model changes
 - Apply prospective
 - Reclassification change in busine
 - SPPI test not rec

Steps to assess change in business model:

2) Look at actual patterns of asset management Ask management:

"Why has the company started selling these bonds or loans mor frequently?"

"Are these sales part of a new policy?"



- Reclassification Rules
 - Only allowed if business model changes
 - Apply prospective
 - Reclassification change in busine
 - SPPI test not rec

Steps to assess change in business model:

- 3) Identify triggers for strategy shift (e.g., M&A, restructuring)
- 4) Review Internal Performance Reporting

Ask management:

"Have you changed how investment performance is reported to the board? Are the now based on fair value rather than interest yield?"

Subsequent Measurement and Reclass

- Reclassification Rules
 - Only allowed if business model changes
 - Apply prospective
 - Reclassification change in busine
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Steps to assess change in business model:

- 5) Check compensation structures
- If management incentives are now based on fair value changes instead of interest collection, this suggests a new model
- 6) Document the evidence

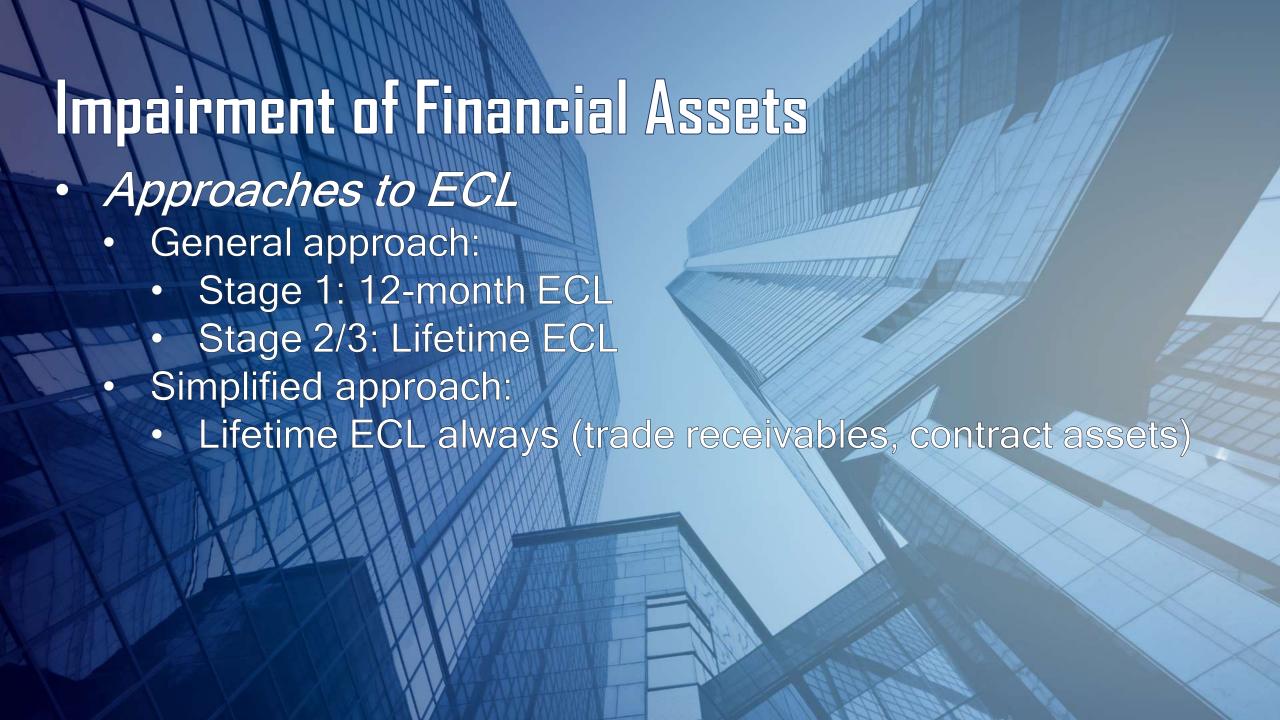


Subsequent Measurement and Reclass

- Practical Application
 - Preparers:
 - Review changes in strategy or business model
 - Update accounting policies if reclassification occur
 - Auditors:
 - Assess if business model change is substantive
 - Check FV hierarchy disclosures for FV assets









- Approaches to ECL
 - General approach:
 - Stage 1: 12-month ECL
 - Stage 2/3: Lifetime ECL
 - Simplified approach:
 - Lifetime ECL a

NOTE:

12-month ECL is NOT losses expected over 12 months; it considers the entire loss amount, but <u>only from default events</u> <u>that are possible in the next 12 months.</u>



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 - General approach:
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 - Stage 2/3: Lifetime ECL
 - Simplified approach:
 - Lifetime E(When to use:
 - Stage 1 Credit risk has not increased significantly (12-month ECL)
 - Stage 2: Credit risk has increased significantly → Lifetime ECL
 - Stage 3: Credit-impaired → Lifetime ECL, interest recognized on net carrying amount.



- Approaches to ECL
 - General approach:
 - Stage 1: 12-month ECL
 - Stage 2/3: Lifetime ECL
 - Simple

ECL = EAD x PD x LGD x Discount Factor

- Where:
 - EAD Exposure at Default
 - PD Probability of Default
 - LGD Loss Given Default

- Approaches to ECL
 - General approach:
 - Stage 1: 12-month ECL
 - Stage 2/3: Lifetime ECL
 - Simr Loan Amount (EAD) = ₱1,000,000
 - PD (12 months) = 3%
 LGD = 50%
 EIR = 5%

ECL = ₱1,000,000 × 3% × 50% = ₱15,000

Discounting is not significant if less than a year.

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PD and LGD in practice:

For Banks:

- internal credit risk models validated by BSP (Basel framework).
- historical data on defaults and recoveries.

- Approaches to ECL
 - General approach:
 - Stage 1: 12-month ECL
 - Stage 2/3: Lifetime ECL
 - Simple
 - PD and LGD in practice:
 - **For Non-financial Corporates:**
 - historical experience with customers (bad debts / write-offs).
 - industry default rates from regulators or credit rating agencies.
 - Adjust based on **current and forward-looking economic factors** (e.g., GDP growth, inflation, unemployment).



- Practical Application
 - Preparers:
 - Develop/document assumptions for PD, LGD, and EAD
 - Update ECL models for forward-looking macroeconomic data
 - Auditors:
 - Challenge management's assumptions and inputs
 - Recalculate sample ECL amounts
 - Verify consistency with disclosures and TB balances









Derecognition and Modifications

- Practical Application
 - Preparers:
 - Watch for sales, factoring, or restructuring that might trigger derecognition
 - Ensure gains/losses recognized in correct period
 - Auditors:
 - Test supporting documents (sale agreements, transfer contracts)
 - Evaluate if transfer qualifies for derecognition





- Overview
 - Single contract with liability and equity components (e.g., convertible bonds)
 - Requires split accounting:
 - Liability = PV of contractual cash flows
 - Equity = Residual amount

- Overview
 - Single contract with liability and equity components (e.g., convertible bonds)
 - Requires split accounting:

 - ·

What to look for:

Repayment Obligation

- There's a contractual obligation to pay cash (principal or interest).
- "The issuer shall pay interest of 5% annually and repay ₱1,000,000 at maturity."

- Overview
 - Single contract with liability and equity components (e.g., convertible bonds)
 - Requires split accounting:
 - · Li
 - · E

What to look for:

Conversion/Equity Feature

- The holder can convert the instrument into shares
- "Each ₱1,000 bond is convertible into 100 ordinary shares of the issuer."

- Overview
 - Single contract with liability and equity components (e.g., convertible bonds)
 - Requires split accounting:
 - Li
 - What to look for:

Fixed-for-Fixed Condition

- The number of shares to be issued is fixed, and the amount to be repaid is fixed.
- "The holder may convert the bond into 500 ordinary shares at any time before maturity."

- Overview
 - Single contract with liability and equity components (e.g., convertible bonds)
 - Requires split accounting:
 - · Li
 - ·E

NOT CFIs!!!

- If there is only conversion and no repayment obligation → It's equity, not a CFI.
- If there is only repayment and no conversion feature → It's debt, not a CFI.
- If conversion price/number of shares is variable → It may be a derivative liability, not equity.







