Hong Kong Institute of
Certified Public Accountants
香港會計師公會

<u>HKFRS 9 (2014) *Financial Instruments*</u>

<u>HKICPA Standard Setting Department Staff Summary (September 2014)</u>

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The HKICPA Standard Setting Department welcomes your comments and feedback, which should be sent to commentletters@hkicpa.org.hk.

Introduction

1. HKFRS 9 (2014) *Financial Instruments* includes a logical model for classification and measurement, a single, forward-looking 'expected loss' impairment model and a substantially-reformed approach to hedge accounting.

2. The standard will be effective for annual periods beginning on or after 1 January 2018. Early application is permitted. Entities will only be permitted to early apply a previous version of HKFRS 9 if their date of initial application is before 1 February 2015. As an exception, the own credit changes can be applied prior to January 2018 at any time in isolation without the need to otherwise change the accounting for financial instruments.

Reasons for issuing HKFRS 9 (2014)

3. The objective of the Hong Kong Institute of Certified Public Accountants (HKICPA) in issuing HKFRS 9 (2014) is to maintain international convergence arising from the issuance of IFRS 9 (2014) by the International Accounting Standards Board (IASB).

4. Many preparers of financial statements, their auditors and users of financial statements find the requirements for reporting financial instruments complex.

5. In 2005, the IASB and the US Financial Accounting Standards Board began working towards a long-term objective of improving and simplifying the reporting for financial instruments. Work was accelerated in response to the financial crisis.

6. The publication of HKFRS 9 (2014) represents the final version of the Standard, replaces earlier versions of HKFRS 9 and completes the project to replace HKAS 39.

Main features of HKFRS 9 (2014)

7. HKFRS 9 (2014) adds to the existing HKFRS 9:

   a. Amendments to classification and measurement of financial assets; and
   b. A new impairment approach for financial assets that are not measured at fair value through profit or loss.

   Amendments to classification and measurement of financial assets

   HKFRS 9 (2014) applies one classification approach for all types of financial assets, including those that contain embedded derivative features. Two criteria are used to determine how financial assets should be classified and measured:

   a. The entity's business model for managing financial assets; and
   b. The contractual cash flow characteristics of the financial asset.

   HKFRS 9 (2014) continues with the approach introduced in HKFRS 9 (2009) (that financial assets are either measured at amortised cost, fair value through other comprehensive income (OCI) for certain equity securities or fair value through profit or loss). It also requires debt instruments that are held within a business model whose objective is achieved by collecting contractual cash flows and selling financial assets to be measured at fair value through OCI (ie interest revenue, impairment gains and losses and foreign exchange gains and losses are recognised in profit or loss in the same manner as for amortised cost assets, while other gains and losses are recognised in other comprehensive income and are reclassified to profit or loss on derecognition).

   New impairment approach

   HKFRS 9 (2014) replaces the 'incurred loss' model in HKAS 39 with an 'expected credit loss' model and the general approach is highlighted as follows:

   Stage 1: As soon as a financial instrument is originated or purchased, 12-month expected credit losses (ie the portion of the lifetime expected credit losses associated with the probability of default events occurring within the 12 months after the reporting date) are recognised in profit or loss and a loss allowance is established, which serves as a proxy for the initial expectations of credit losses.

   The calculation of interest revenue on these financial assets is based on the gross carrying amount (ie without adjustment for expected credit losses).

   Stage 2: At each reporting date, a loss allowance for full lifetime expected credit losses (ie the present value of all cash shortfalls over the remaining life of the financial instrument) is recognised if the credit risk has increased significantly since initial recognition and the resulting credit quality is not considered to be low credit risk. Lifetime expected credit losses are only recognised if the credit risk increases significantly from when the entity originates or purchases the financial instrument. The calculation of interest revenue on financial assets remains the same as for Stage 1. HKFRS 9 (2014) does not define what is meant by 'significant' and so judgement will be needed.

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 amortised cost (ie the gross carrying amount adjusted for the loss allowance). Financial assets in this stage are individually assessed in general and lifetime expected credit losses are still recognised on these financial assets.

When measuring expected credit losses, an entity should consider:

a. The probability-weighted outcome: expected credit losses should represent neither a best or worst-case scenario. Rather, the estimate should reflect the probability that a credit loss occurs and the probability that no credit loss occurs;
b. The time value of money: expected credit losses should be discounted to the reporting date; and
c. Reasonable and supportable information that is available at the reporting date without undue cost or effort, and that includes information about past events, current conditions and forecasts of future conditions.

Simplified approach: For certain trade and lease receivables, and for contract assets (recognised in accordance with HKFRS 15 *Revenue from Contracts with Customers*), a simplified approach is made available. Instead of requiring to keep track of changes in credit risk, the simplified approach requires the recognition of lifetime expected credit losses at all times.

Disclosure: Entities are required to provide information that explains the basis for their expected credit loss calculations and how they measure expected credit losses and assess changes in credit risk.

In addition, entities are required to provide a reconciliation from the opening to the closing allowance balances for 12-month loss allowances separately from lifetime loss allowance balances. This is provided along with a reconciliation from the opening to the closing balances of the related carrying amounts of financial instruments subject to impairment.

The reconciliations are required to be provided in a way that enables users of financial statements to understand the reason for changes in the allowance balances (such as whether it is caused by changes in credit risk or increased lending).

Information is also required to be provided about the credit risk of financial assets by rating grades and about financial assets on which contractual cash flows have been modified.

Other references on HKFRS/IFRS 9

1. Deloitte IFRS in Focus
http://www.iasplus.com/en/publications/global/ifrs-in-focus/2014/ifrs9

2. EY 'IFRS Developments'
Classification and measurement
http://www.ey.com/Publication/vwLUAssets/IFRS_Developments,_Issue_86:_IASB_issues_IFRS_9_Financial_Instruments_–_classification_and_measurement/$File/Devel86-FI-CM-Jul2014.pdf

Expected credit losses
http://www.ey.com/Publication/vwLUAssets/IFRS_Developments,_Issue_87:_IASB_issues_IFRS_9_Financial_Instruments_–_expected_credit_losses/$File/Devel87-FI-ECL-Jul2014.pdf

3. IASB Project Summary on IFRS 9 *Financial Instruments*
http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/Documents/IFRS-9-Project-Summary-July-2014.pdf

4. KPMG Financial Reporting Update
http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/Financial-Reporting-Update/Documents/Financial-Reporting-Update-1409-79.html

5. PwC 'In depth'
Classification and measurement
https://inform.pwc.com/inform2/show?action=informContent&id=1457050208164674

Expected credit losses
https://inform.pwc.com/inform2/show?action=informContent&id=1441115508150948