HKFRS 9 (2014) - Classification and Measurement of Financial Assets and Financial Liabilities

Introduction

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. This HKFRS update will cover the classification and measurement of financial assets and financial liabilities but exclude the requirements on impairment and hedge accounting.

Classification determines how financial assets and financial liabilities are accounted for in financial statements and, in particular, how they are measured on an ongoing basis. HKFRS 9 (2014) introduces a logical approach for the classification of financial assets, which is driven by cash flow characteristics and the business model in which an asset is held.

HKFRS 9 (2014) also removes the volatility in profit or loss that was caused by changes in the credit risk of liabilities elected to be measured at fair value. This change in accounting means that gains caused by the deterioration of an entity's own credit risk on such liabilities are no longer recognised in profit or loss.

Effective Date

HKFRS 9 (2014) is effective for annual periods beginning on or after 1 January 2018 with earlier application permitted.

Summary of Requirements

Classification and measurement of financial assets

01 Amortised cost measurement category

A financial asset shall be measured at amortised cost if both of the following conditions are met:

- the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

02 FVTOCI measurement category (will be recycled to profit or loss)

A financial asset shall be measured at fair value through other comprehensive income (“FVTOCI”) if both of the following conditions are met:

- the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

This measurement category recognises information in profit or loss as if the financial asset is measured at amortised cost, while the financial asset is measured in the statement of financial position at fair value. Interest calculated using the effective interest method is recognised in profit or loss.

The financial asset is treated as a monetary item and is treated as an asset measured at amortised cost in the foreign currency. Exchange differences on the amortised cost are recognised in profit or loss.

Other gains or losses are recognised in other comprehensive income. When the financial asset is derecognised, cumulative gains or losses previously recognised in other comprehensive income are reclassified to profit or loss.

Classification and measurement of financial assets

FVTOCI measurement category (will not be recycled to profit or loss)

03

An entity may make an irrevocable election at initial recognition for investments in equity instruments to present subsequent changes in fair value in other comprehensive income. The equity instruments are neither held for trading nor contingent consideration recognised by an acquirer in a business combination.

This election is made on an instrument-by-instrument (i.e. share-by-share) basis. Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. Dividends on such investments are recognised in profit or loss unless the dividend clearly represents a recovery of part of the cost of the investment.

FVTPL measurement category

04

Other financial assets shall be measured at fair value through profit or loss ("FVTPL") with gains or losses recognised in profit or loss. Dividends on such investments are recognised in profit or loss.

An entity may, at initial recognition, irrevocably designate a financial asset as measured at FVTPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

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Classification and measurement of financial assets

05 Business model whose objective is to hold assets in order to collect contractual cash flows

Financial assets that are held within a business model whose objective is to hold assets in order to collect contractual cash flows are managed to realise cash flows by collecting contractual payments over the life of the instrument. Information about past sales and expectations about future sales provide evidence related to how this objective is achieved and, specifically, how cash flows are realised. An entity must consider information about past sales within the context of the reasons for those sales and the conditions that existed at that time as compared to current conditions.

The entity need not hold all of those instruments until maturity. This business model is met even when sales of financial assets occur or are expected to occur in the future. Sales due to an increase in the assets' credit risk are not inconsistent with this business model because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows.

Sales that occur for other reasons, such as sales made to manage credit concentration risk, may also be consistent with this business model. An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's business model. In addition, sales may be consistent with this objective if the sales are made close to the maturity of the financial assets and the proceeds from the sales approximate the collection of the remaining contractual cash flows.

Paragraph B4.1.4 of HKFRS 9 (2014) provides examples of when the objective of an entity's business model may be to hold financial assets to collect the contractual cash flows.

06 Business model whose objective is achieved by both collecting contractual cash flows and selling financial assets

In this type of business model, the entity has made a decision that both collecting contractual cash flows and selling financial assets are integral to achieving the objective of the business model. There are various objectives that may be consistent with this type of business model. For example, the objective of the business model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding.

Compared to a business model whose objective is to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and value of sales. However, there is no threshold for the frequency or value of sales that must occur in this business model because both collecting contractual cash flows and selling financial assets are integral to achieving its objective.

Paragraph B4.1.4C of HKFRS 9 (2014) provides examples of when the objective of the entity's business model may be achieved by both collecting contractual cash flows and selling financial assets.

Classification and measurement of financial assets

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Other business models

Financial assets are measured at FVTPL if they are not held within a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. One such business model is in which an entity manages the financial assets with the objective of realising cash flows through the sale of the assets. The entity makes decisions based on the assets' fair values and manages the assets to realise those fair values. Even though the entity will collect contractual cash flows while it holds the financial assets, the objective of such a business model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the business model's objective; instead, it is incidental to it.

A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis is also an example. The entity is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions. A portfolio of financial assets that meets the definition of held for trading is another example. For such portfolios, the collection of contractual cash flows is only incidental to achieving the business model's objective.

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Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. Interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative. However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage.

Classification and measurement of financial assets

08

If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows, the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. The following are examples of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:

(a) a variable interest rate that consists of consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time and other basic lending risks and costs, as well as a profit margin;

(b) a contractual term that permits the issuer (i.e. the debtor) to prepay a debt instrument or permits the holder (i.e. the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract; and

(c) a contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument (i.e. an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.

Paragraph B4.1.13 of HKFRS 9 (2014) provides examples illustrate contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraph B4.1.14 of HKFRS 9 (2014) provides examples illustrate contractual cash flows that are not solely payments of principal and interest on the principal amount outstanding.

Classification and measurement of financial liabilities

An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for:

(a) financial liabilities at FVTPL. Such liabilities, including derivative liabilities, shall be subsequently measured at fair value with gains or losses recognised in profit or loss. However, the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability shall be presented in other comprehensive income. Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. If this treatment of the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in profit or loss, an entity shall present the effects of changes in the credit risk of that liability in profit or loss.

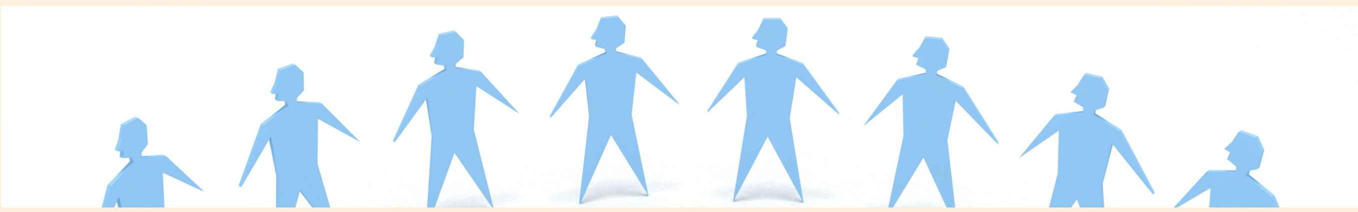
An entity shall present in profit or loss all gains and losses on loan commitments and financial guarantee contracts that are designated as at FVTPL.

An entity may, at initial recognition, irrevocably designate a financial liability as measured at FVTPL when doing so results in more relevant information, because either:

- it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
- a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel.

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability. The transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:

- the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost, or
- equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.



Classification and measurement of financial liabilities

(c) financial guarantee contracts. After initial recognition, an issuer of such a contract shall (except paragraphs (a) or (b) applies) subsequently measure it at the higher of:

- the amount of the loss allowance determined and
- the fair value amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of HKFRS 15 "Revenue from Contracts with Customers".

(d) commitments to provide a loan at a below-market interest rate. An issuer of such a commitment shall (unless paragraph (a) applies) subsequently measure it at the higher of:

- the amount of the loss allowance determined and
- the fair value amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of HKFRS 15.

(e) contingent consideration recognised by an acquirer in a business combination to which HKFRS 3 "Business Combinations" applies. Such contingent consideration shall subsequently be measured at fair value with changes recognised in profit or loss.

Embedded derivatives

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

If a hybrid contract contains a host that is an asset within the scope of HKFRS 9 (2014), an entity shall apply the requirements on classification of financial assets to the entire hybrid contract.

If a hybrid contract contains a host that is not an asset within the scope of HKFRS 9 (2014), an embedded derivative shall be separated from the host and accounted for as a derivative if, and only if:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss.

If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate HKFRS.

If a contract contains one or more embedded derivatives and the host is not an asset within the scope of HKFRS 9 (2014), an entity may designate the entire hybrid contract as at FVTPL unless:

- the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or
- it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited.

If an entity is required by HKFRS 9 (2014) to separate an embedded derivative from its host, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at FVTPL.

Guidance on amortised cost measurement

01

Revisions to estimated cash flows

For floating-rate financial assets and floating-rate financial liabilities, periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate. If a floating-rate financial asset or a floating-rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or the liability.

If an entity revises its estimates of payments or receipts (excluding modifications of cash flows of financial assets as described below), it shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability to reflect actual and revised estimated contractual cash flows. The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate. The adjustment is recognised in profit or loss as income or expense.

02

Modifications of cash flows of financial assets

When the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a modification gain or loss in profit or loss. The gross carrying amount of the financial asset shall be recalculated as the present value of the renegotiated or modified contractual cash flows that are discounted at the financial asset's original effective interest rate.

Any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset. However, there is no guidance on how such costs and fees are amortised. An acceptable method is that such costs and fees adjusted to the carrying amount alter the effective interest rate.

Guidance on amortised cost measurement

Modifications of cash flows of financial liabilities

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A substantial modification of the terms of an existing financial liability or a part of it shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

The terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

There is no guidance on how to account for the modification of a financial liability that is not substantial. An acceptable method is to follow the guidance on modifications of cash flows of financial assets as described above.

Reclassification

An entity shall not reclassify any financial liability.

When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets. The following are not changes in business model:

- a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).
- the temporary disappearance of a particular market for financial assets.
- a transfer of financial assets between parts of the entity with different business models.

If an entity reclassifies financial assets, it shall apply the reclassification prospectively from the reclassification date. The entity shall not restate any previously recognised gains, losses or interest.

01 Amortised cost and FVTPL measurement category

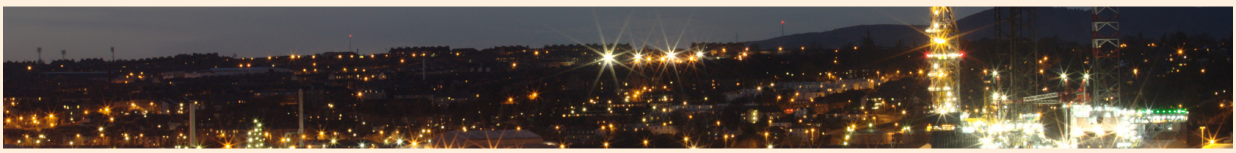
If an entity reclassifies a financial asset out of the amortised cost measurement category and into the FVTPL measurement category, its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortised cost of the asset and fair value is recognised in profit or loss.

If an entity reclassifies a financial asset out of the FVTPL measurement category and into the amortised cost measurement category, its fair value at the reclassification date becomes its new gross carrying amount. The effective interest rate is determined on the basis of the fair value of the asset at the reclassification date.

02 Amortised cost and FVTOCI measurement category

If an entity reclassifies a financial asset out of the amortised cost measurement category and into the FVTOCI measurement category, its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortised cost of the asset and fair value is recognised in other comprehensive income. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification.

If an entity reclassifies a financial asset out of the FVTOCI measurement category and into the amortised cost measurement category, the financial asset is reclassified at its fair value at the reclassification date. However, the cumulative gain or loss previously recognised in other comprehensive income is removed from equity and adjusted against the fair value of the asset at the reclassification date. As a result, the financial asset is measured at the reclassification date as if it had always been measured at amortised cost. This adjustment affects other comprehensive income but does not affect profit or loss and therefore is not a reclassification adjustment. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification.



Reclassification

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FVTPL and FVTOCI measurement category

If an entity reclassifies a financial asset out of the FVTPL measurement category and into the FVTOCI measurement category, the financial asset continues to be measured at fair value. The effective interest rate is determined on the basis of the fair value of the asset at the reclassification date.

If an entity reclassifies a financial asset out of the FVTOCI measurement category and into the FVTPL measurement category, the financial asset continues to be measured at fair value. The cumulative gain or loss previously recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment at the reclassification date.

Investments in equity instruments and contracts on those investments

All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. Indicators that cost might not be representative of fair value include:

(a) a significant change in the performance of the investee compared with budgets, plans or milestones.

(b) changes in expectation that the investee's technical product milestones will be achieved.

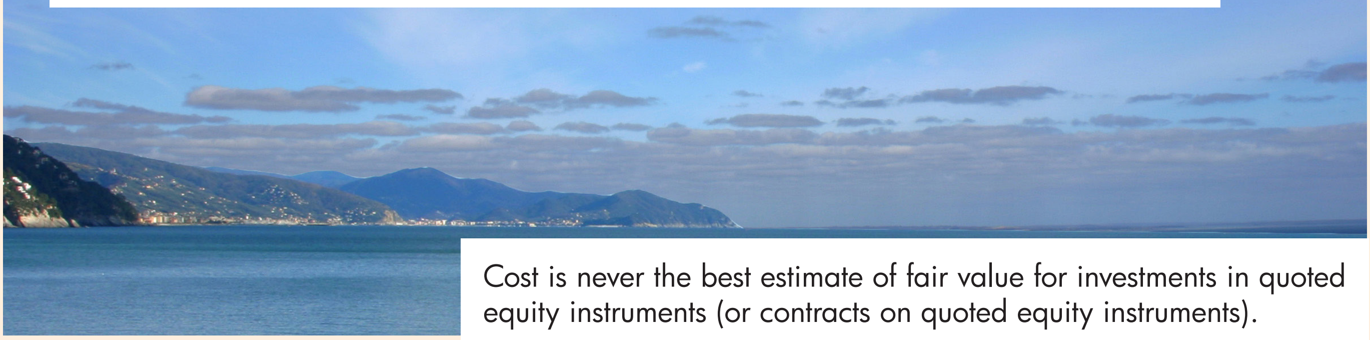
(c) a significant change in the market for the investee's equity or its products or potential products.

(d) a significant change in the global economy or the economic environment in which the investee operates.

(e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.

(f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.

(g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.



Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

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