HKFRS 9 (2014) *Financial Instruments* completes comprehensive IASB response to financial crisis

The publication of HKFRS 9 (2014) *Financial Instruments* draws to a close the project to replace HKAS 39 *Financial Instruments: Recognition and Measurement.* The standard includes a logical model for classification and measurement; a single, forward-looking "expected loss" impairment model; and a substantially reformed approach to hedge accounting. The changes introduced in the standard are highlighted as follows:

Classification and measurement of financial instruments

HKFRS 9 (2014) applies one classification approach for all types of financial assets, including those that contain embedded derivative features. Financial assets are therefore classified in their entirety rather than being subject to complex bifurcation requirements.

Two criteria are used to determine how financial assets should be classified and measured:

- The entity's business model for managing financial assets; and
- 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 amortized cost, fair value through other comprehensive income for certain equity securities or fair value through profit or loss) and also allows debt instruments to be measured at fair value through OCI if they are held in a particular business model. In order to be classified at fair value through OCI, a debt instrument needs to have simple principal and interest cash flows and be held in a business model in which both holding and selling financial assets are integral to meeting management's objectives.

This change provides more structure around the classification of these types of assets, and results in better information in the primary financial statements as it directly reflects both the nature of the instrument's contractual cash flows and the business model in which that instrument is held.

If a financial asset is a simple debt instrument and the objective of the entity's business model within which it is held is to collect its contractual cash flows, the financial asset is measured at amortized cost. In contrast, if that asset is held in a business model the objective of which is achieved by both collecting contractual cash flows and selling financial assets, then the financial asset is measured at fair value through OCI (i.e. interest revenue, impairment gains and losses and foreign exchange gains and losses are recognized in profit or loss in the same manner as for amortized cost assets, while other gains and losses are recognized in OCI and are reclassified to profit or loss on derecognition).

Impairment

The biggest difference under the new standard is in the accounting for impairment. During the financial crisis, the delayed recognition of credit losses on loans (and other financial instruments) was identified as a weakness in existing accounting standards. Specifically, the existing model in HKAS 39 (an "incurred loss" model) delays the recognition of credit losses until there is evidence of a trigger event.

As the financial crisis unfolded, it became clear that the incurred loss model gave room to a different kind of earnings management, namely, to postpone losses. Even though HKAS 39 did not require waiting for actual default before impairment was recognized, in practice this was often the case. In addition, multiple impairment models in HKAS 39 for financial instruments were also identified as concerns. For example, it was confusing that the same credit-impaired bond could have an impairment amount recognized based on either market prices, or on contractual cash flows, simply because it was classified as available-for-sale or held-to-maturity, respectively.

The main objective of the new impairment requirements is to provide users of financial statements with more useful information about an entity's expected credit losses on financial instruments. The model requires an entity to recognize expected credit losses on a more continuous basis and to update the amount of expected credit losses recognized at each reporting date to reflect changes in the credit risk of financial instruments.

This model is forward-looking and eliminates the threshold for the recognition of expected credit losses, so that it is no longer necessary for a trigger event to have occurred before credit losses are recognized. Consequently, more timely information must be provided about expected credit losses, which help address concerns by many investors about the recognition of impairment being "too little, too late."

Furthermore, when credit losses are measured in accordance with HKAS 39, an entity may only consider those losses that arise from past events and current conditions. The effects of possible future credit loss events could not be considered, even when they are expected. The requirements in HKFRS 9 (2014) broaden the information that an entity is required to consider when determining expectations of credit losses.

In order to address the criticism for multiple impairment models contained in HKAS 39, under HKFRS 9 (2014) the same impairment model is applied to all financial instruments that are subject to impairment accounting, removing a major source of current complexity. This includes financial assets classified as amortized cost and fair value through other comprehensive income, lease receivables, trade receivables, and commitments to lend money and financial guarantee contracts. The new impairment

approach is summarized as follows:

Stage 1
As soon as a financial instrument is originated or purchased, 12-month expected credit losses (i.e. 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 recognized 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 (i.e. without adjustment for expected credit losses).

Stage 2
At each reporting date, a loss allowance for full lifetime expected credit losses (i.e. the present value of all cash shortfalls over the remaining life of the financial instrument) is recognized 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 recognized 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 judgment 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 amortized cost (i.e. 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 recognized on these financial assets.

When measuring expected credit losses, an entity should consider:

- 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;
- The time value of money: expected credit losses should be discounted to the reporting date; and
- 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.

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

Accounting for changes in "own credit"
HKFRS 9 (2014) essentially does not change accounting for financial liabilities. Consequently, the vast majority of financial liabilities continue to be measured at amortized cost. However, the main criticism in relation to accounting for financial liabilities concerned the accounting treatment of changes in "own credit" (i.e. the counterintuitive effects which arise when an entity's credit quality declines but a gain is booked in profit or loss if its liabilities are measured at fair value). While HKFRS 9 (2014) still requires liabilities that an entity elects to measure at fair value to be recognized in the statement of financial position at fair value, the standard requires the portion of fair value changes caused by changes in the entity's own credit risk to be recognized in OCI rather than in profit or loss.

To enable early adoption, an entity that applies HKFRS 9 (2014) before 1 January 2018 can choose to apply this change to its accounting for financial instruments in isolation (i.e. prior to applying any other parts of HKFRS 9 (2014)).

Hedge accounting
HKFRS 9 (2014) includes the new hedge accounting requirements that had been published in draft in December 2013. These improvements to hedge accounting address concerns and criticisms about shortcomings in the prior model and the information provided about risk management. As a result, the new hedge accounting model more closely aligns risk management and accounting.

Disclosure
Expected credit losses reflect management's expectations of shortfalls in the collection of contractual cash flows. As the new impairment model requires the application of significant judgment, HKFRS 9 (2014) introduces disclosures to assist investors and analysts understand the amount of expected credit losses, the basis for their measurement and the reasons for changes in expected credit losses over time. In particular, entities are required to provide information about key assumptions used in the measurement of expected credit losses, and how an entity determines whether there has been a significant increase in credit risk.

In addition, entities are required to provide a reconciliation of the opening and closing expected credit loss amounts and associated opening and closing financial instrument carrying amounts. Information about the changes in the financial instruments' carrying amounts have to be provided in a way that enables investors and analysts to understand the main drivers of changes in the amount of expected credit losses.

These disclosures are required to be provided separately for different categories (such as 12-month and lifetime loss amounts) and by class of financial instrument.

HKFRS 9 (2014) is mandatory from 1 January 2018 but may be adopted earlier.

This article is contributed by the Institute's Standard Setting Department