Why the new requirements for classifying financial instruments, do, matter

At first glance, the new classification and measurement requirements in HKFRS 9 *Financial Instruments* (equivalent to IFRS 9 of the same title) may not seem very different from what we have today.

In fact, the new requirements (to supersede HKAS 39 *Financial Instruments: Recognition and Measurement* on its effective date of 1 January 2018) will result in differences that do matter for those preparing as well as reading financial statements.

Why it matters – financial assets

HKFRS 9 significantly changes the approach to classification and measurement for financial assets.

HKAS 39 currently prescribes four different rule-based classification and measurement criteria and approaches for financial assets. Preparers of financial statements face application complexity, while users of financial statements face understandability issues.

HKFRS 9 has fundamentally overhauled the many criteria and approaches by replacing them with a single approach for all types of financial assets. This change in HKFRS 9 not only provides simplicity for entities as they prepare their financial statements, but also provides more structure for investors reading the 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.

Why it matters – financial liabilities

HKFRS 9 essentially does not change the approach to classification and measurement for financial liabilities – the vast majority of financial liabilities will continue to be measured at amortized cost. The key change that is significant to the accounting for financial liabilities relates to an entity's own debt measured at fair value.

Currently, entities that issue bonds (or the like) measured at fair value may suffer from the "own credit" effect. That is, when an entity's creditworthiness falls, the fair value of their own debt also decreases, which counter-intuitively causes a gain to be recognized in the profit or loss. This was especially apparent during the financial crisis causing concern to investors worldwide.

HKFRS 9 provides a significant improvement by now requiring the portion of fair value changes caused by an entity's own creditworthiness to be recognized in other comprehensive income rather than in profit or loss.

As entities are often asked by investors to remove the "own credit" effect from profit or loss, this improvement means that this adjustment will no longer be necessary and is good news for investors. Entities can choose to apply this improvement in isolation prior to 1 January 2018.

What does this mean for you?

Act now! With only 18 months until the standard is effective, all entities should be reviewing their contractual arrangements as an immediate first step to implementing the new classification and measurement requirements of HKFRS 9. The flow chart and table on the next page details the comprehensive assessment that management will have to make for financial assets. Management should also assess what new data it might require, assess the need to change its reporting systems and communicate the impact of the standard to your capital providers and other stakeholders to prevent any last-minute surprises.

Other publications

Our May 2016 *A Plus* article discussed the implementation issues specific to the new HKFRS 9 impairment model, while our May 2015 *A Plus* article provided a general overview of the HKFRS 9 implementation challenges facing banks and other corporate entities. Both articles are available on the Institute's website as further references.

Classification differences between HKAS 39 and HKFRS 9

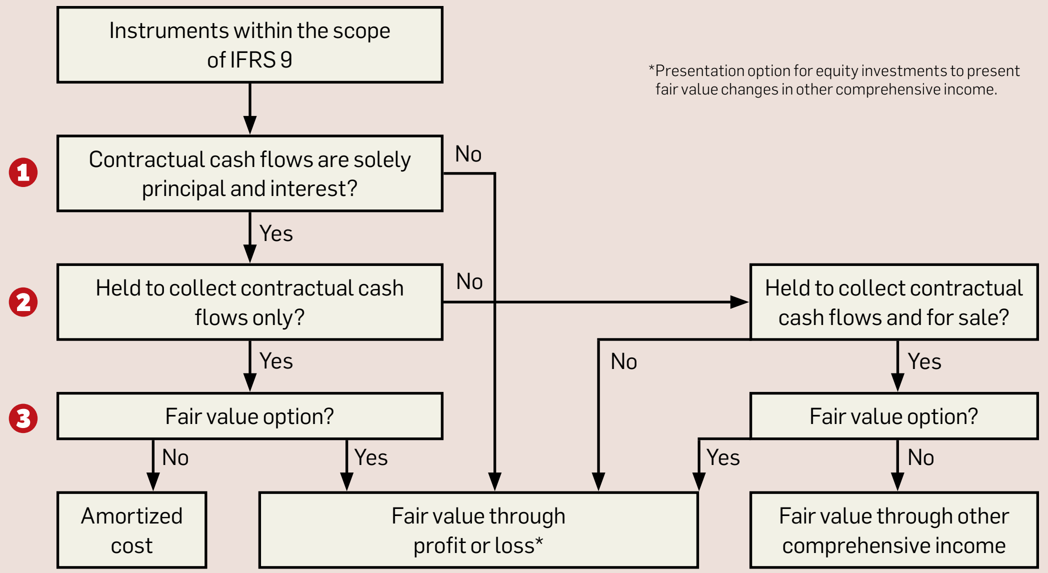
IAS 39 *Classification*
- Rule-based
- Complex and difficult to apply
- Multiple impairment models
- Own credit gains and losses recognized in profit or loss for fair value option liabilities
- Complicated reclassification rules

IFRS 9 *Classification*
- Principle-based
- Classification based on business model and nature of cash flows
- One impairment model
- Own credit gains and losses presented in other comprehensive income for fair value option liabilities
- Business model-driven reclassification

Source: IASB's project summary of IFRS 9 issued in July 2014

Determining the classification and measurement of financial assets

The following diagram summarizes the classification and measurement process for financial assets.



Source: Adapted from IASB's project summary of IFRS 9 issued in July 2014

1 Cash flow characteristics – Contracted cash flows are solely principal and interest?

Entities will have to assess whether their contractual cash flows are consistent with a basic lending arrangement solely made up of payments of principal and interest. The principal amount is the fair value of the financial asset at initial recognition. The interest amount represents consideration received for: time value of money and credit risk; basic lending risks (e.g. liquidity risks); other associated costs (e.g. administrative costs); and a profit margin.

2 Business model – Held to collect contractual cash flows only?

Entities will have to make a factual assessment based on how the financial assets are managed. This is typically observable through activities that the entity undertakes and is not based on the intent for the individual instrument. The determining factor to classification will be how the cash flows are realized. Cash flows could be realized in one of two business model forms: (a) hold to collect, which means that the entity generates value by collecting contractual cash flows only; or (b) hold to collect and sell, which means that the entity generates value by collecting contractual cash flows and selling the financial asset.

In determining which of the two business models the cash flows of an entity's financial assets fall into, entities are reminded to consider past sales information and future expectations. Hold to collect cash flows may also contain some infrequent or insignificant sales. Hold to collect and sell cash flows will involve a greater frequency and volume of sales and the sale could be determined by, for example, an entity's liquidity needs, interest yield management, asset or liability management.

HKFRS 9 requires financial assets to be reclassified between measurement categories when, and only when, the entity's business model for managing them changes.

3 Designation option – Fair value option?

An entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency. This is commonly referred to as an "accounting mismatch" between assets and liabilities.

Entities might choose to designate their financial assets and/or financial liabilities at fair value through profit or loss if doing so would better reflect the way the entity manages its business.

Get in touch with the Institute's Standard Setting Department (*outreachhk@hkicpa.org.hk*) if you have any questions on or issues with implementing HKFRS 9. Also, look out for more Institute seminars on implementing HKFRS 9, which will be released soon.

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