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THE IMPENDING CALAMITY? OR IS IT NOT?

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THE IMPENDING CALAMITY? OR IS IT NOT?

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The sky is falling !! The sky is falling !! That was the first impression of the market especially from financial institutions regarding the expected loss model introduced under MFRS 9. What is the expected loss model? How will it affect us? What about non-financial institutions? Can they ignore the standard? In this article, we would like to take the opportunity to separate the myth from the facts of the new standard on financial instruments.

MFRS 9 Financial Instruments is the replacement of ***MFRS 139 Financial Instruments: Recognition and Measurement***. MFRS 9 stipulates requirements for recognition and measurement, impairment, de-recognition and general hedge accounting.

The version of MFRS 9 issued in 2014 supersedes all previous versions and is effective for periods beginning on or after 1 January 2018 with early adoption permitted.

In this article, we would cover the following areas:

- classification and measurement of financial instruments; and
- impairment;

EXPECTED LOSS MODEL INTRODUCED UNDER MFRS 9

CLASSIFICATION AND MEASUREMENT OF FINANCIAL INSTRUMENTS

Under MFRS 9 all financial instruments are initially measured at fair value plus or minus transaction costs.

Subsequent to initial recognition, all financial assets within the scope of MFRS 9 are either measured at:

1. amortised cost;
2. fair value through other comprehensive income (FVTOCI); or
3. fair value through profit or loss (FVTPL).

The FVTOCI classification is mandatory for certain debt instrument assets such as bonds unless the option to FVTPL is taken.

The accounting treatment for returns from investments in equity instruments designated at FVTOCI such as dividend income is recognised in profit or loss with all other gains and losses recognised in Other Comprehensive Income (OCI).

1 DEBT INSTRUMENTS

A debt instrument that meets the following two conditions must be measured at amortised cost unless the asset is designated at FVTPL under the fair value option:

BUSINESS MODEL TEST:

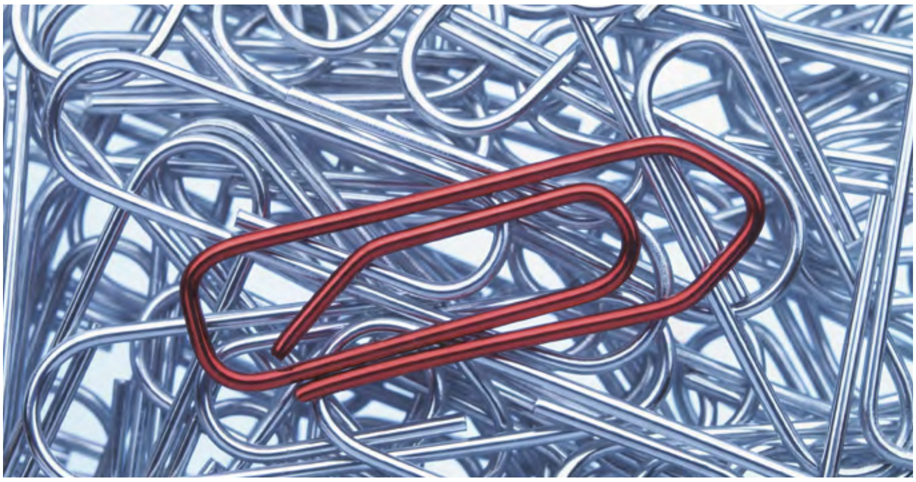
The financial asset is held within a business model whose objective is to hold financial assets to collect their contractual cash flows

(rather than to sell the assets prior to their contractual maturity to realise changes in fair value).

CASH FLOW CHARACTERISTICS TEST:

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.

A debt instrument that meets the cash flow characteristics test and is not designated at FVTPL under the fair value option must be measured at FVTOCI if it is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and sell financial assets.



BUSINESS MODEL ASSESSMENT

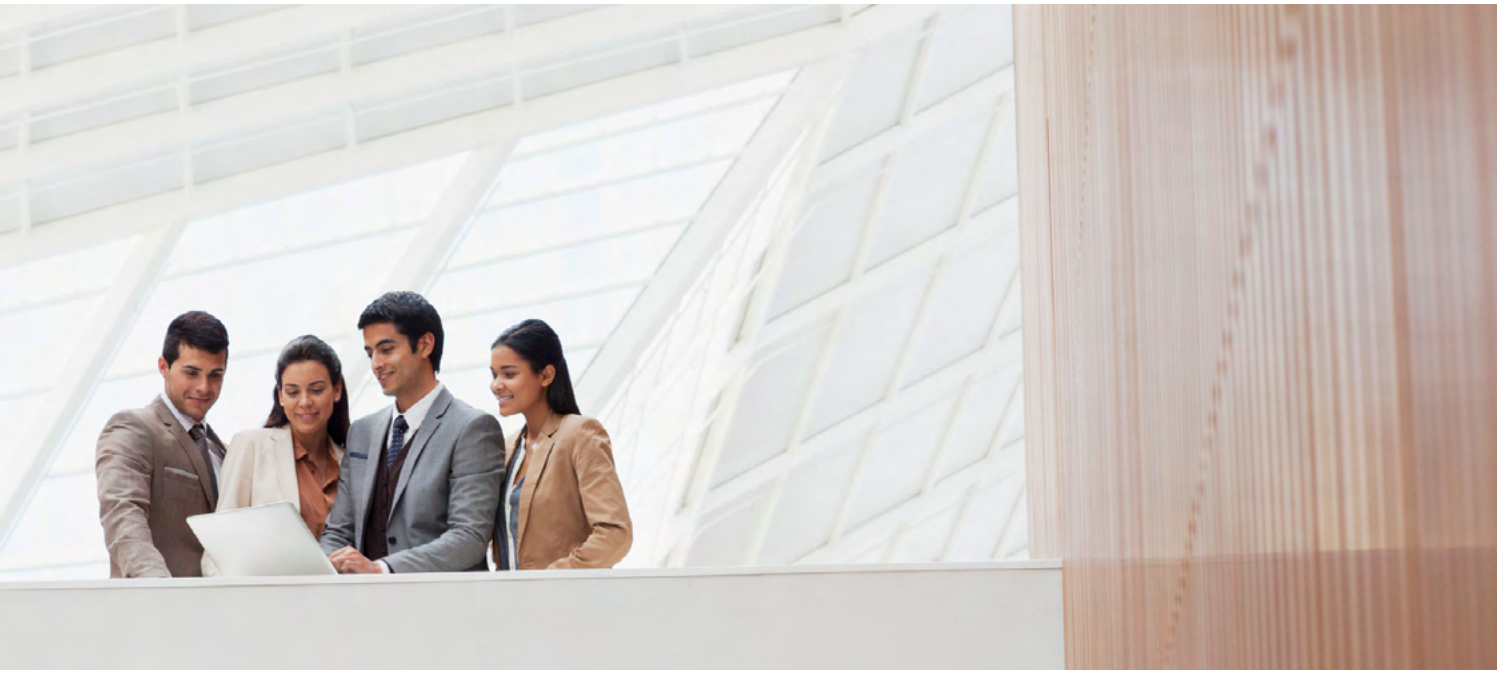
An assessment of business models for managing financial assets is fundamental to the classification of financial assets. An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The entity's business model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined at a higher level of aggregation.

CONTRACTUAL CASH FLOW CHARACTERISTICS TEST

Only debt instruments are capable of meeting the contractual cash flows characteristics test required by MFRS 9.

MFRS 9 contains detailed guidance regarding the assessment of the contractual cash flows of an asset and has specific requirements for non-recourse assets and contractually linked instruments.

All other debt instrument assets are measured at FVTPL.



2 FAIR VALUE OPTION

MFRS 9 contains an option to designate, at initial recognition, a financial asset as measured at FVTPL if doing so eliminates or significantly reduces an 'accounting mismatch' that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases. Financial assets designated at FVTPL are not subject to the reclassification requirements of MFRS 9.

EQUITY INVESTMENTS

All equity investments in scope of MFRS 9 are measured at fair value in the statement of financial position, with value changes recognised in profit or loss, except for those equity investments for which the entity has elected to present value changes in other comprehensive income.

The option to designate an equity instrument at FVTOCI is available at initial recognition and is irrevocable. This designation results in all gains and losses being presented in OCI except dividend income which is recognised in profit or loss.

3 FINANCIAL LIABILITIES: SUBSEQUENT MEASUREMENT

The MFRS 9 accounting model for financial liabilities is broadly similar to that in MFRS 139. However, there are two key differences compared to MFRS 139 notably:

TWO KEY DIFFERENCES COMPARED TO MFRS 139

The presentation of effects of changes in fair value attributable to an entity's credit risk. Financial liabilities held for trading, (e.g. derivative liabilities), as well as loan commitments and financial guarantee contracts that are designated at FVTPL under the fair value option, will continue to be measured at fair value with all changes being recognised in profit or loss.

However, for all other financial liabilities designated as at FVTPL using the fair value option, MFRS 9 requires the amount of the change in the liability's fair value attributable to changes in the credit risk to be recognised in OCI with the remaining amount of change in fair value recognised in profit or loss, unless this treatment of the credit risk component creates or enlarges a measurement mismatch. Amounts presented in other comprehensive income are not subsequently transferred to profit or loss.

- **FAIR VALUE OPTION**

The MFRS 9 eligibility requirements for applying the fair value option to measure financial liabilities at FVTPL are consistent with those of MFRS 139.

- **RECLASSIFICATION**

For financial assets, reclassification is required between FVTPL, FVTOCI and amortised cost; if and only if the entity's business model objective for its financial assets changes.

MFRS 9 DOES NOT ALLOW RECLASSIFICATION:

1. **when the fair value option has been elected in any circumstance for a financial asset;**
2. **or equity investments** (measured at FVTPL or FVTOCI);
3. **or for financial liabilities.**

If an entity reclassifies a financial asset, it is required to apply the reclassification prospectively from the reclassification date, defined as the first day of the first reporting period following the change in business model that results in the entity reclassifying financial assets. Previously recognised gains, losses (including impairment gains or losses) or interest are not restated.

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IMPAIRMENT

MFRS 9 introduces a new impairment model based on expected losses, (rather than incurred loss as per MFRS 139) which has a wider scope of application than MFRS 139.

SCOPE:
MFRS 9 requires the same expected loss impairment model to apply to all of the following:
- financial assets measured at amortised cost;
- financial assets mandatorily measured at FVTOCI;
- loan commitments when there is a present obligation to extend credit (except where these are measured at FVTPL);
- financial guarantee contracts to which MFRS 9 is applied (except those measured at FVTPL);
- lease receivables within the scope of MFRS 16 Leases ; and
- contract assets within the scope of MFRS 15 Revenue from Contracts with Customers.

GENERAL APPROACH

With the exception of purchased or originated credit-impaired financial assets (which are considered separately below), expected credit losses are required to be measured through a loss allowance at an amount equal to:

1. 12-month expected credit losses (expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date); or

2. lifetime expected credit losses (expected credit losses that result from all possible default events over the life of the financial instrument).

A loss allowance for lifetime expected credit losses is required for a financial instrument if the credit risk on that financial instrument has increased significantly since initial recognition. It is also required for contract assets or trade receivables that are not, according to MFRS 15, considered to contain a significant financing component.

Additionally, entities can elect an accounting policy of recognising lifetime expected credit losses for all contract assets and/or all trade receivables, including those that contain a significant financing component. The same election is also separately permitted for lease receivables.

For all other financial instruments, expected credit losses are measured at an amount equal to the 12-month expected credit losses.

SIGNIFICANT INCREASE IN CREDIT RISK

A significant increase in credit risk is defined as a significant increase in the probability of a default occurring since initial recognition. Under the Standard, an entity may use various approaches to assess whether credit risk has increased significantly (provided that the approach is consistent with the MFRS 9 requirements). An approach can be consistent with the requirements even if it does not include an explicit probability of default occurring as an input.

The application guidance provides a list of factors that may assist an entity in making the assessment. Also, whilst in principle the assessment of whether a loss allowance should be based on lifetime expected credit losses is to be made on an individual asset basis, some factors or indicators might not be available at an instrument level.

In this case, the entity should perform the assessment on appropriate groups or portions of a portfolio of financial instruments. The requirements contain a rebuttable presumption that the credit risk has increased significantly when contractual payments are more than 30 days past due.

MFRS 9 also requires that (other than for purchased or originated credit impaired financial instruments) if a significant increase in credit risk that had taken place since initial recognition, has reversed by a subsequent reporting period (i.e., at the reporting date credit risk has not significantly increased since initial recognition) then the loss allowance reverts to 12-month expected credit losses.

MFRS 9 also allows an entity to assume that the credit risk on a financial instrument has not increased significantly if it is determined to have a 'low' credit risk at the reporting date. The Standard considers credit risk to be 'low' if there is a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. The Standard suggests that an 'investment grade' rating might be an indicator for a low credit risk.

PURCHASED OR ORIGINATED CREDIT-IMPAIRED FINANCIAL ASSETS

Purchased or originated credit-impaired financial assets are treated differently because the asset is credit-impaired at initial recognition. For these assets, an entity would recognise all changes in lifetime expected credit losses since initial recognition as a loss allowance with any changes recognised in profit or loss. Under the requirements, any favourable changes for such assets are an impairment gain even if the resulting expected cash flows of a financial asset exceed the estimated cash flows on initial recognition.

CREDIT-IMPAIRED FINANCIAL ASSETS

Under MFRS 9 a financial asset is credit-impaired when one or more events have occurred that have a detrimental impact on the expected future cash flows of the financial asset. It includes observable data that has come to the attention of the holder of a financial asset about the following events:

- significant financial difficulty of the issuer or borrower;
- a breach of contract, such as a default or past-due event;
- the lenders for economic or contractual reasons relating to the borrower's financial difficulty granting the borrower a concession that would not otherwise be considered;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market or the financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects incurred credit losses.

BASIS FOR ESTIMATING EXPECTED CREDIT LOSSES

The measurement of expected credit losses shall reflect an unbiased and probability-weighted amount that is determined by evaluating the range of possible outcomes as well as incorporating the time value of money. Also, the entity should consider reasonable and supportable information about past events, current conditions and reasonable and supportable forecasts of future economic conditions when measuring expected credit losses.

The Standard defines expected credit losses as the weighted average of credit losses with the weightings being the respective risks of a default occurring. Not every possible scenario must be considered but, at a minimum, the risk or probability that a credit loss occurs must be considered, even if the probability of a credit loss occurring is low.

An entity is required to incorporate reasonable and supportable information (i.e., that which is reasonably available at the reporting date). Information is reasonably available if obtaining it does not involve undue cost or effort (with information available for financial reporting purposes qualifying as such).

CONCLUSION

MFRS 9 is actually not an impending calamity but a standard that would ease the technical practicality of MFRS 139. By embracing the new standard, companies and financial institution can better apply the concept set forward by the MFRS 139 but with less confusion. BDO Malaysia as a big five professional services firm will be confidently able to provide training to interested parties.

To ensure a smooth sailing journey, our experts at BDO would be pleased to be called upon including providing necessary training to interested stakeholders.

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