

HKFRS News

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IFRS/HKFRS 9 *Financial Instruments* introduces new requirements for financial assets

What is the issue?

IFRS 9 *Financial Instruments* addresses classification and measurement of financial assets was issued by the IASB on 12 November 2009 and the identical HKFRS 9 was issued on 19 November 2009 by HKICPA respectively. Both standards are available for early adoption immediately. The classification and measurement of financial liabilities remain within IAS/HKAS 39 for the time being. The major changes to existing guidance in HKAS 39 are outlined below.

- HKFRS 9 replaces the multiple classification and measurement models in HKAS 39 with a single model that has only two classification categories: amortised cost and fair value. Classification under HKFRS 9 is driven by the entity's business model for managing the financial assets and the contractual characteristics of the financial assets. A financial asset is measured at amortised cost if two criteria are met: a) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows, and b) the contractual cash flows under the instrument solely represent payments of principal and interest.
- The new standard removes the requirement to separate embedded derivatives from financial asset hosts. It requires a hybrid contract to be classified in its entirety at either amortised cost or fair value. Most embedded derivatives introduce variability to cash flows. This is not consistent with the notion that the instrument's contractual cash flows solely represent the payment of principal and interest. Most hybrid contracts with financial asset hosts will therefore be measured at fair value in their entirety. Hybrid contracts with financial liability hosts remain within HKAS 39's rules on separation of embedded derivatives.
- Two of the existing three fair value option criteria as applied to financial assets become obsolete under HKFRS 9, as a fair value driven business model requires fair value accounting, and hybrid contracts with financial asset hosts are classified in their entirety. The remaining fair value option condition in HKAS 39 is carried forward to the new standard – that is, management may still designate a financial asset as at fair value through profit or loss on initial recognition if this significantly reduces an accounting mismatch. The designation at fair value through profit or loss will continue to be irrevocable.
- HKFRS 9 prohibits reclassifications except in rare circumstances when the entity's business model changes; in this case, the entity is required to reclassify affected financial assets prospectively.
- There is specific guidance for contractually linked instruments that create concentrations of credit risk, which is often the case with investment tranches in a securitisation. In addition to assessing the instrument itself against the HKFRS 9 classification criteria, management should also 'look through' to the underlying pool of instruments that generate cash flows to assess their characteristics. To qualify for amortised cost, the investment must have equal or lower credit risk than the weighted-average credit risk in the underlying pool of instruments, and those instruments must meet certain criteria. If 'a look through' is impracticable, the tranche must be classified at fair value through profit or loss.



HKFRS has converged with IFRS effective from 1 January 2005. Contents contained in this newsletter are relevant to both HKFRS preparers and IFRS preparers.

- HKFRS 9 classification principles indicate that all equity investments should be measured at fair value. However, management has an option to present in other comprehensive income unrealised and realised fair value gains and losses on equity investments that are not held for trading. Such designation is available on initial recognition on an instrument-by-instrument basis and is irrevocable. There is no subsequent recycling of fair value gains and losses to profit or loss; however, dividends from such investments will continue to be recognised in profit or loss.
- HKFRS 9 removes the cost exemption for unquoted equities and derivatives on unquoted equities but provides guidance on when cost may be an appropriate estimate of fair value.

IFRS 9 represents the first milestone in the IASB's planned replacement of IAS 39. The next steps involve reconsideration and re-exposure of the classification and measurement requirements for financial liabilities, further exploration and field testing of the proposed impairment approach for financial assets, and development of enhanced guidance on hedge accounting. The IASB is also likely to publish a request for views on the FASB comprehensive exposure draft on financial instruments, which is expected to be issued in the first quarter of 2010. The IASB aims to fully replace IAS 39 by the end of 2010. In accordance with its usual policy, the HKICPA will publish equivalent documents to those issued by the IASB.

Am I affected?

All entities that hold financial assets will be affected, but banks and insurance companies will be the most significantly impacted by the new standard. The degree of the impact will depend on the type and significance of financial assets held by the entity and the entity's business model(s) for managing financial assets.

The effective date of the new classification and measurement guidance is 1 January 2013; early application is permitted. HKFRS 9 should be applied retrospectively; however, if adopted before 1 January 2012, comparative periods do not need to be restated. In addition, entities adopting before 1 January 2011 are allowed to designate any date between then and the date of issuance of HKFRS 9, as the date of initial application that will be the date upon which the classification of financial assets will be determined.

What do I need to do?

Management should familiarise themselves with the detailed requirements of HKFRS 9 and evaluate the effects of the new standard on the classification and measurement of financial assets held by the entity. Management should consider the potential benefits of early adoption of the new guidance in light of the provided relief from restatement of comparative information and the relaxed requirements for the determination of the date of initial application for early adopters.

However, management should bear in mind that the financial instruments project is evolving. The IASB has indicated that the effective date of IFRS 9 may be pushed back to align the mandatory adoption of the standard with the effective dates for IAS 39 replacement stage II – 'Amortised cost and impairment' and 'Insurance' projects. In addition, there may be changes in the financial statements presentation for financial assets to enable investors to more easily reconcile the IASB and FASB models. It can be expected that the HKICPA would make similar changes to timing and content to keep HKFRS aligned with IFRS.

Management and other interested parties should monitor the IAS 39 replacement project and consider the impact of further decisions in the context of requirements already established by IFRS 9 and HKFRS 9.

Contacts

For further help, please contact:

Hong Kong

22/F Prince's Building
Central, Hong Kong
Tel: +852 2289 8888

Beijing

26/F Office Tower A
Beijing Fortune Plaza
7 Dongsanhuan Zhong Road
Chaoyang District
Beijing 100020, PRC
Tel: +86 (10) 6533 8888

Shanghai

11/F
PricewaterhouseCoopers
Center
202 Hu Bin Road
Shanghai 200021, PRC
Tel: +86 (21) 2323 8888

Chongqing

Room 1905
19/F Metropolitan Tower
68 Zou Rong Road
Chongqing 400010, PRC
Tel: +86 (23) 6393 7888

Dalian

8/F Senmao Building
147 Zhongshan Road
Xigang District
Dalian 116011, PRC
Tel: +86 (411) 8379 1888

Guangzhou

25/F Center Plaza
161 Lin He Xi Road
Guangzhou 510620, PRC
Tel: +86 (20) 3819 2000

Macau

28/F Unit C
Bank of China Building
Avenida Doutor Mario
Soares, Macau
Tel: +853 8799 5111

Ningbo

Room 202, Tower C
(Sheraton Ningbo Hotel)
Portman Plaza
50 Caihong Road North
Jiangdong District
Ningbo 315040, PRC
Tel: +86 (574) 8773 6888

Qingdao

4601 Qingdao
International Finance Center
59 Hong Kong Middle Road
Qingdao 266071, PRC
Tel: +86 (532) 8089 1888

Shenzhen

38/F Shun Hing Square
Di Wang Commercial Centre
5002 Shennan Road East
Shenzhen 518008, PRC
Tel: +86 (755) 8261 8888

Singapore

8 Cross Street #17-00
PWC Building
Singapore 048424
Tel: +65 6236 3388

Suzhou

Room 1501
Genway Tower
188 Wang Dun Road
Suzhou Industrial Park
Suzhou 215028, PRC
Tel: +86 (512) 6273 1888

Tianjin

17/F The Exchange
Tower One
189 Nanjing Road,
Heping District
Tianjin 300051, PRC
Tel: +86 (22) 2330 6789

Xiamen

Unit B
11/F International Plaza
8 Lujiang Road
Siming District
Xiamen 361001, PRC
Tel: +86 (592) 210 7888

Xi'an

Room 728
Zhongda International
Mansion
30 Nan Da Street
Xi'an 710002, PRC
Tel: +86 (29) 8720 3336



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