

# PwC Alert

## Embracing the new financial instruments standard – MFRS 9

### *Page 3*

Section 1 – Classification and  
measurement of financial assets

### *Page 8*

Section 2 – Classification and  
measurement of financial liabilities

### *Page 9*

Section 3 – Impairment

### *Page 14*

Section 4 – Hedge accounting

### *Page 16*

Implementation challenges





## *A brand new MFRS on financial instruments*

The Malaysian Accounting Standards Board has issued a brand new MFRS on the recognition and measurement of financial instruments – MFRS 9. This new standard is word for word that of IFRS 9 issued by the International Accounting Standards Board (“IASB”). It will replace the existing MFRS 139 “Financial Instruments: Recognition and Measurement” from 1 January 2018.

MFRS 9 introduces changes in the following 4 areas:

1. Classification and measurement of financial assets;
2. Accounting for changes in own credit risk in financial liabilities;
3. Impairment; and
4. Hedge accounting

The new standard nevertheless retains certain principles in MFRS 139. The requirements on derecognition of financial assets and liabilities as well as classification and measurement of financial liabilities remain unchanged.

The presentation and disclosure requirements of financial instruments remain the subject of MFRS 132 “Financial instruments: Presentation” and MFRS 7 “Financial Instruments: Disclosures” respectively. Consequential amendments were also made to these standards in conjunction with the new requirements introduced by MFRS 9.

In this article, we give an overview of the key changes introduced by MFRS 9 and the resulting implications

## *The call for change*

IAS 39 “Financial Instruments: Recognition and Measurement” has been widely criticized as a rule-based standard which is complex and difficult to understand and apply. Some believed the incurred loss model in IAS 39 resulted in impairment loss being recognised too late and too little during the global financial crisis. In response to these criticisms and requests of the G20 leaders, the IASB accelerated its plan to reform the financial instruments standard in April 2009.

The IASB took approximately 5 years to complete this project by phases and the complete version of IFRS 9 was finally published in July 2014 after six Exposure Drafts, one Supplementary Document and a Discussion Paper. The IASB in its press release prescribed “IFRS 9 includes a logical model for classification and measurement, a single, forward-looking expected loss impairment model and a substantially-reformed approach to hedge accounting”.



# Section 1 - Classification and measurement of financial assets

## Rule-based approach in MFRS 139 versus principle-based approach in MFRS 9

MFRS 139		MFRS 9
Amortised Cost	Held-to-maturity	Amortised Cost
	Loans and receivables	
Fair Value	Available-for-sale	Fair Value through Other Comprehensive Income (FVOCI)
	Held for trading	Fair Value through Profit or Loss (FVTPL)

The new classification and measurement requirements of MFRS 9, on the surface, do not seem to be very different from the existing requirements in MFRS 139. Many has criticized that the requirements in MFRS 139 are complex and rule-based. To improve the decision-usefulness of the financial statements, MFRS 9 adopts an entirely new principal-based approach to classify and measure financial assets. Accordingly, financial assets may be measured differently upon the adoption of the new standard.

Two criteria are used in MFRS 9 to determine the classification and measurement of financial assets:

- (1) The entity's business model for managing the financial assets; and
- (2) The cash flows characteristics of the financial assets.

MFRS 9 permits financial assets to be measured at amortised cost if both of the following criteria are met:

- The objective of the entity's business model is to hold the financial asset in order to collect its contractual cash flows; and
- The contractual cash flows represent solely payments of principal and interest ("SPPI") on the principal amount outstanding.

### At a glance

*MFRS 9 continues with a mixed measurement model (i.e. amortised cost, FVTPL and FVOCI) to account for financial assets. The measurement basis is driven by the entity's business model and cash flows characteristics of the financial asset.*

If the financial assets meet the SPPI criteria and the business model of the entity is achieved by both collecting contractual cash flows and selling the financial assets, the assets should be measured at fair value through other comprehensive income ("FVOCI"). This is different from the available-for-sale category in MFRS 139, which is generally an unrestricted category.

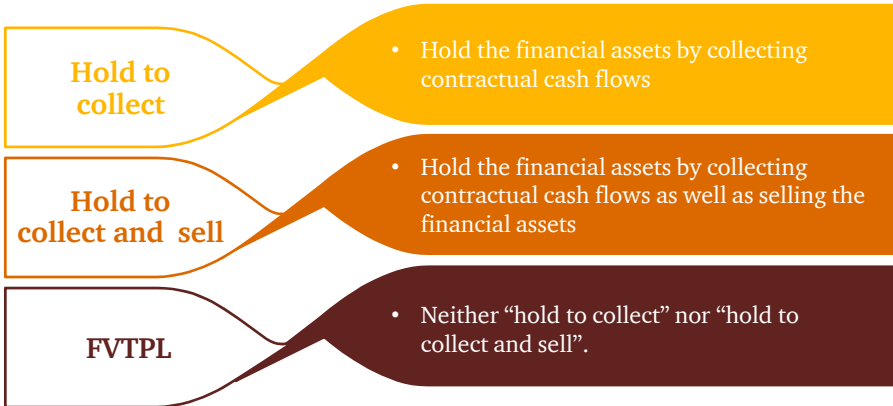
All other financial assets (including equity instruments and derivatives) are measured at fair value through profit or loss ("FVTPL"), which is the residual category in MFRS 9.

Despite the above, an entity can always elect to classify a financial asset at fair value through profit or loss if doing so will reduce or eliminate a measurement or recognition inconsistency (which we often call this an accounting mismatch).

MFRS 9 applies one classification approach for all types of financial assets, including those that contain embedded derivatives. Financial assets are classified and measured in its entirety and embedded derivatives are not separately accounted for. This is different from the existing MFRS 139 requirement.

## Section 1 - Classification and measurement of financial assets

### Business model assessment



One should take note that an entity’s business model does not depend on management’s intention for an individual instrument. It is not a matter of accounting policy choice. Instead, it is a matter of fact that can be observed by the way an entity is managed and information is provided to its key management personnel. Accordingly, an entity might have the same type of instrument (such as government bonds) in all 3 categories of business model depending on its model for managing the assets.

Some of the key considerations in determining a business model include:

- How the performance of the business model (and the financial assets held within) is evaluated and reported to the entity’s key management personnel;
- The risks that affect the performance of the business model (and the financial assets held within) and, in particular the way that those risks is managed; and
- How managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or the contractual cash flows collected).

The existing tainting provision in MFRS 139 on held-to-maturity financial assets (which requires entity to demonstrate that it has the ability and intention to hold a financial asset to maturity) is not replicated in MFRS 9. Hence, although the business model of an entity might be ‘hold to collect’, the entity need not hold all of those instruments until maturity. However, there are guidance provided in the standard that preparers should consider and assess whether sales are within the ‘hold to collect’ business model (e.g. reason and historical frequency of sales).

Changes in business model result in reclassification, but changes are expected to be rare.

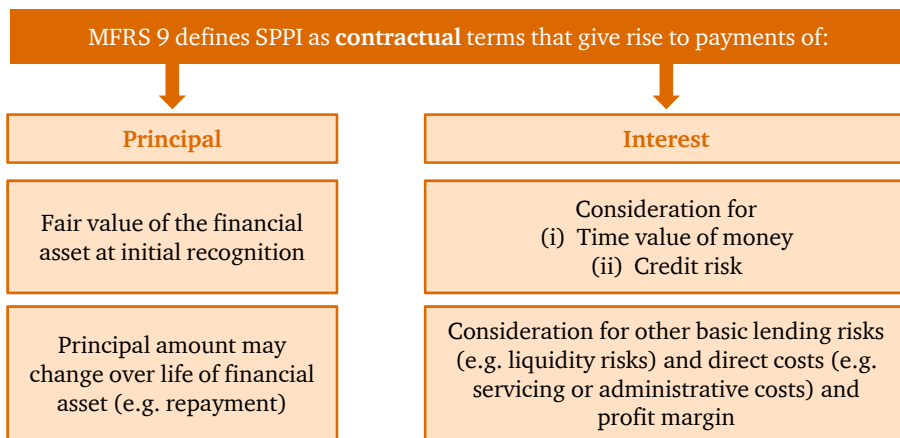
#### **PwC observation**

*An entity may have more than one business models for managing its financial assets. For example, an entity may hold a portfolio of investments that it monitors to realise fair value changes and another portfolio of investments that it manages to collect the contractual cash flows.*

#### **PwC observation**

*Even though sales do not drive the business model assessment, management should be clear about the reason for such sales when determining if sales would prevent a financial asset from being classified within ‘hold to collect’ business model.*

## Contractual cash flows analysis



### *PwC observation*

*An embedded derivative that creates a variability to the contractual cash flows (such as conversion option embedded in a bond) does not meet the SPPI condition and accordingly the entire financial asset is measured at FVTPL.*

The SPPI cash flow assessment shall be performed taking into account all the contractual cash flows that could arise over the life of the instrument. Such assessment shall include all provisions including prepayment, extension options and other contractual terms.

SPPI assessment is to be carried out in the currency in which the financial asset is denominated.



## Section 1 - Classification and measurement of financial assets

### Classification of investments in equity instruments

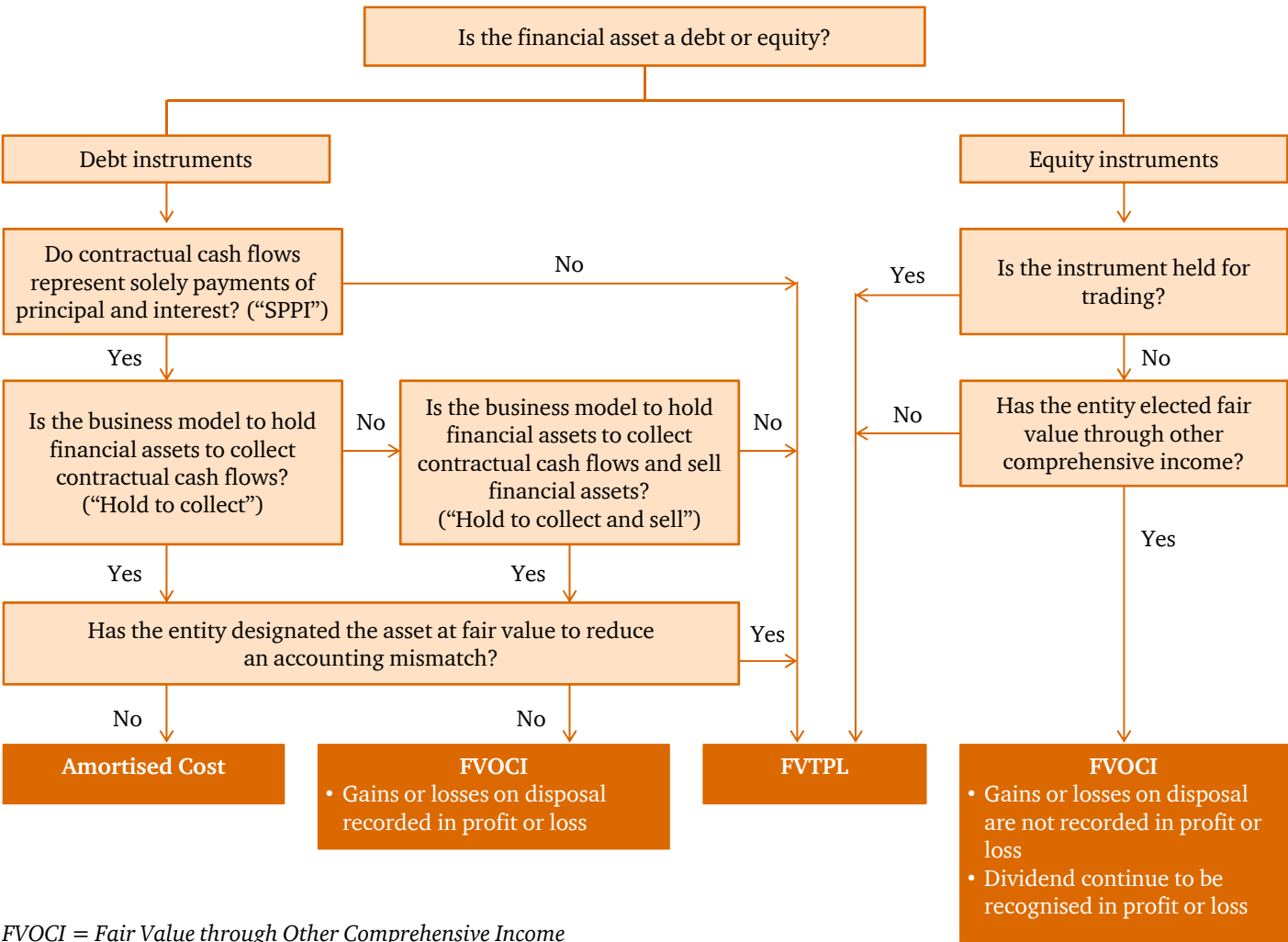
Investments in equity instruments are always measured at fair value and those that are held for trading are required to be measured at FVTPL. For all other equity investments, management can elect on initial recognition, to present changes in fair value through other comprehensive income (“OCI”). This election is available on an instrument-by-instrument basis and is irrevocable.

The MFRS 9’s classification of investments in equity instrument is similar to MFRS 139, other than there is no reclassification of gains or losses from OCI to profit or loss (for example, on sale of the equity instrument). In addition, dividend income continues to be recognised in the profit or loss.

MFRS 9 also clarifies that equity instruments are those that meet the definition of ‘equity’ from the perspective of the issuer as defined in MFRS 132 “Financial Instruments: Presentation”. This would have an implication on investment in puttable shares (e.g. unit trust held) which are commonly classified under the available-for-sale category in MFRS 139. MFRS 132 permits, as an exception to its principles, certain puttable shares to be classified as equity from the issuer’s perspective. However, such puttable shares, from the holder’s perspective, do not meet the definition of equity instrument for the purpose of financial asset classification in MFRS 9. These puttable shares are therefore debt instruments which need to meet both the SPPI and “hold to collect and sell” business model in order to be measured at FVOCI. Since there is no contractual cash flows for such investments, these puttable shares will not meet the SPPI criteria, and are therefore required to be measured at FVTPL under MFRS 9.



The following diagram provides an overview of the MFRS 9 classification and measurement model for financial assets. Whilst MFRS 9 adopts a more logical approach on classification, there are rules governing the resulting measurement.



*FVOCI = Fair Value through Other Comprehensive Income*  
*FVTPL = Fair Value through Profit or Loss*



## Section 2 - Classification and measurement of financial liabilities

MFRS 9 retained the classification and measurement requirements in MFRS 139 on financial liabilities. There continue to be two measurement categories for financial liabilities – amortised cost and fair value through profit or loss (“FVTPL”).

Different from financial assets, entities still require to separate derivatives embedded in financial liabilities and measured them at FVTPL, if they are considered not closely related to the host contract.

If an entity chooses to measure a financial liability at FVTPL, MFRS 9 requires changes in fair value related to changes in own credit risk to be presented separately in OCI but not in profit or loss. This amendment is in response to the criticism that it’s counter intuitive if an entity recognises gain in profit or loss when its credit quality deteriorates. Moreover, an entity generally will not realise the effects of changes in its own liability’s credit risk unless the liability is held for trading.

### At a glance

*The classification and measurement principles of financial liabilities in MFRS 139 are mostly retained. The only change is that entity is required to present fair value changes arising from its own credit risk in OCI and not profit or loss.*





## Section 3 - Impairment

One of the main criticism on the MFRS 139's impairment model is the delay in recognition of credit losses due to the need for a loss event to occur. Understandably, the biggest change under MFRS 9 would be, impairment based on expected credit losses even if a loss event has not occurred. This would result in entities needing to book in day 1 credit losses.

Under the current MFRS 139 regime, impairment is measured differently depending on how a financial asset is classified and measured. This is another major criticism cited by users of financial statements. The ECL calculation in MFRS 9 introduces a single impairment model for all financial instruments subject to credit risk, regardless of the types of instruments held and how they are classified and measured.

The general approach in MFRS 9 outlines a three-stage impairment model based on changes in credit quality since initial recognition (as illustrated in Panel 1). Assets move through the three stages as credit quality changes and the stages dictate how an entity measures impairment losses at each reporting date. Impairment will be reversed if the credit quality improves. However, a minimum impairment of 12-month ECL is required to be recognised at all times.

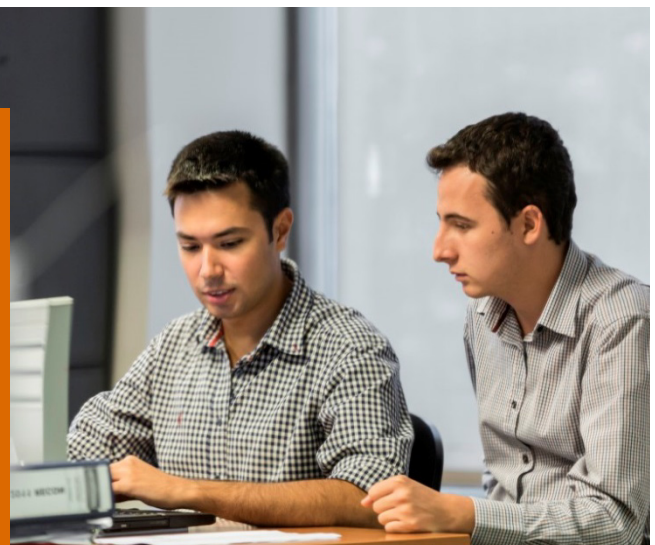
### At a glance

*MFRS 9 introduces a single impairment measurement model known as the expected credit losses ("ECL") model for all financial instruments subject to credit risk, regardless of the type of instruments held and how they are measured. Entities are required to book in day 1 credit losses under the ECL model. The occurrence of loss event (i.e. impairment indicator) is not required before an impairment is recognised.*

#### *The new ECL model should be applied to:*

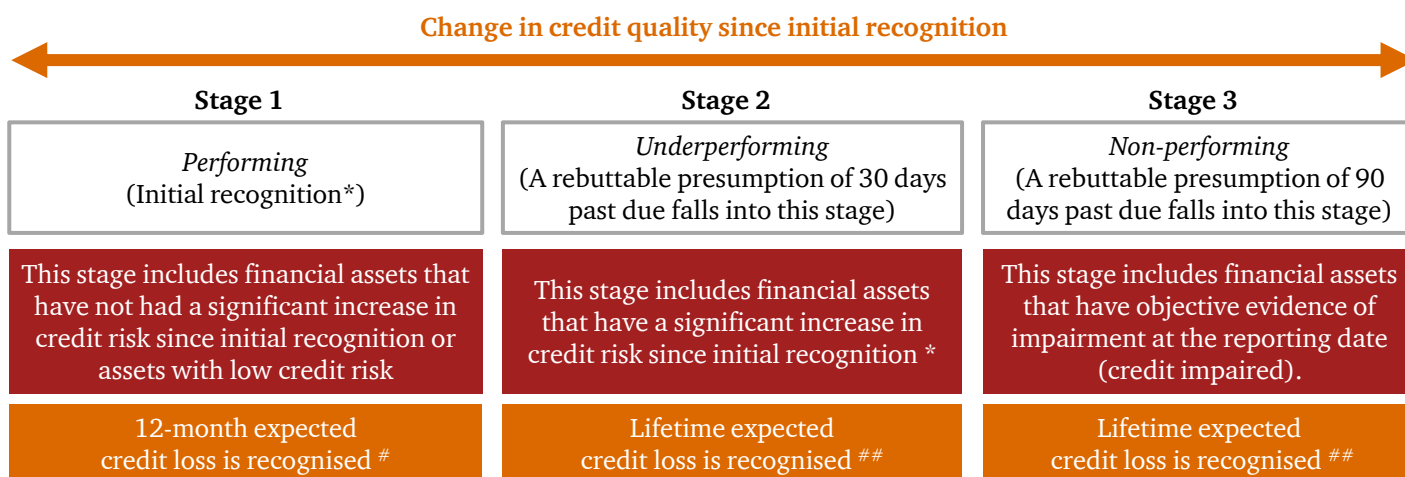
- Investments in debt instruments measured at amortised cost and FVOCI
- All loan commitments not measured at FVTPL
- Financial guarantee contracts within the scope of MFRS 9 and are not accounted for at FVTPL
- Lease receivables within the scope of MFRS 117 "Leases", and trade receivables or contract assets within the scope of MFRS 15 "Revenue from Contracts with Customers" that give rise to an unconditional right to consideration.

Investments in equity instrument are no longer subject to impairment assessment. This is because ECL is all about credit losses, i.e. the risk that one party will cause a financial loss for the other party by failing to discharge an obligation.



## Section 3 - Impairment

### Panel 1 – The three-stage general approach on recognition of ECL



\* Except for purchased or originated credit impaired assets

# 12-month ECL is the entire credit loss on an asset weighted by the probability that the loss will occur in the next 12 months. The 12-month ECL does not equal to the expected cash shortfalls over the 12-month period

## Lifetime ECL is the expected credit losses that result from all possible default events over the expected life of the asset

### Measurement of the ECL

A credit loss is the difference between the present value (“PV”) of cash flows that are due to an entity in accordance with the contract and the PV of cash flows that the entity expects to receive. As ECL consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than the contractual due date.

In determining ECL, entities are required to make use of reliable and supportable forward looking information as at reporting date other than historical loss and current information. Such information may consist of the macro economic factors relevant to the financial instrument (Panel 2 lists some information that entities may consider).

Entities are not required to use a ‘crystal ball’ to predict the future – what an entity uses depends on the information that is available at the reporting date without undue cost or effort.

The calculation of ECL shall also include a probability weighted outcome and time value of money. An entity is not required to consider each and every possible scenario. However, it shall consider the risk or probability that a credit loss occurs even if the possibility of a credit loss occurring is very low.

Entities can perform ECL assessment at an individual instrument or a collective level. Management can group financial assets on a basis of shared credit risk characteristics if by doing so would enable significant increases in credit risk to be identified on a timely basis.

If management does not have forward looking information available at an individual instrument level, and therefore assess significant increases in credit risk using historical information only, MFRS 9 requires management to also consider forward looking information at a collective level when assessing changes in credit risk.

Panel 2



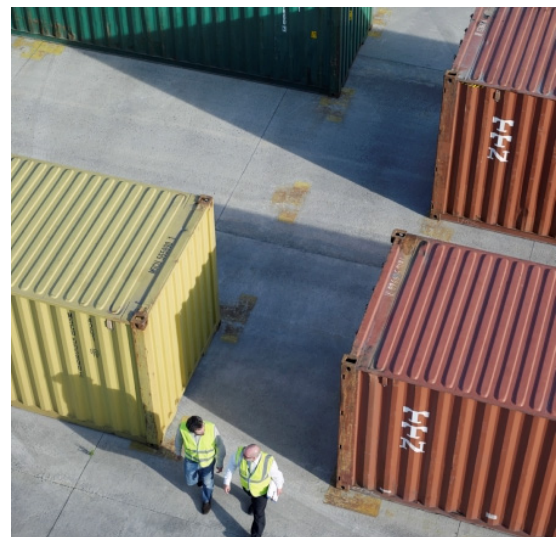
## Section 3 - Impairment

### The simplified approach – operational simplifications for trade receivables, contract assets and lease receivables

The ECL model includes some operational simplifications for trade receivables, contract assets and lease receivables (as illustrated in Panel 3). These simplifications eliminate the needs to calculate the 12-month ECL and to assess when a significant increase in credit risk has occurred. Rather, a lifetime ECL is recorded when the financial asset is first recognised.

Allowing this option for selected financial assets would reduce comparability, the IASB however, believes it would alleviate some of the practical concerns of tracking changes in credit risk for entities that do not have sophisticated credit risk management systems.

As a practical expedient, a provision matrix may be used to estimate the lifetime ECL when applying the simplified approach.



**Panel 3 - Application of simplified approach to different types of financial assets**

Types of financial assets	Applicable impairment approach	Measurement of ECL
Trade receivables without significant financing component*	Must apply simplified approach	Lifetime ECL is recognised
Trade receivables with significant financing component*	Accounting policy choice to apply either:	Depends on the accounting policy choice made:
Lease receivables	1. Three-stage general approach; or 2. Simplified approach	1. Three-stage general approach – Lifetime or 12-month ECL depending on whether there is any significant increase in credit risk  2. Simplified approach - Lifetime ECL is recognised from initial recognition

\* 'Significant financing component' is determined in accordance with MFRS 15 "Revenue for Contracts with Customers."



## The potential impacts to reporting entities

The new impairment model would give rise to challenges in implementation particularly on getting the appropriate data and setting a consistent approach. In determining the appropriate data, entities need to ensure there is a correlation of the data and the credit risk of its financial assets. Whilst historical information is essential in the ECL model, entities will need to incorporate forward looking information to these historical information in the process of estimating ECL. Significant judgements and active participation from key management is expected in the process of determining whether the credit risk on a financial instrument has increased significantly.

### PwC observation

*We expect impairment losses to be higher moving forward with the shift from an incurred loss to an expected loss model. Given the degree of judgement involved in estimating the impairment loss, the new standard introduces heightened level of disclosures on the judgements made and information used to arrive at the impairment.*

In recognition of the complexity involved to implement ECL, the IASB has formed a Transition Resource Group for Impairment of Financial Instruments to facilitate discussions on potential implementation challenges faced by preparers. Members of this Group includes preparers and auditors with expertise, skills or practical knowledge of ECL.



## Section 4 – Hedge accounting

### The changes and how they affect reporting entities

Hedging in an economic sense involves the reduction of an entity's exposure to a particular risk such as price risk, currency risk, interest rate risk associated with a particular transaction.

Hedge accounting, on the other hand, is an accounting technique that modifies the normal basis for recognising gains or losses arising from hedging instruments (such as derivatives) and hedged items so that both are recognised in profit or loss in the same accounting period. Therefore, hedge accounting does not change the overall performance of the entity over time. Rather, it affects only the timing and presentation of profits or losses.

The rules on hedge accounting in MFRS 139 have frustrated many preparers. The requirement often is not linked to the common risk management practices and at times, results in achieving hedge accounting impossible or very costly.

The new hedging guidance in MFRS 9 aims to address these criticism by improving the alignment of hedge accounting with risk management activities of an entity and establishing a more principle-based approach to hedge accounting. Panel 4 highlights some notable changes. However, the requirement of formal designation and documentation to be in place at the inception of the hedge relationship is retained.

### At a glance

*MFRS 9 improves the decision-usefulness of the financial statements by better aligning hedge accounting with the risk management activities of an entity. It makes some fundamental changes to the existing requirements by removing or amending some of the key prohibitions and rules within MFRS 139.*

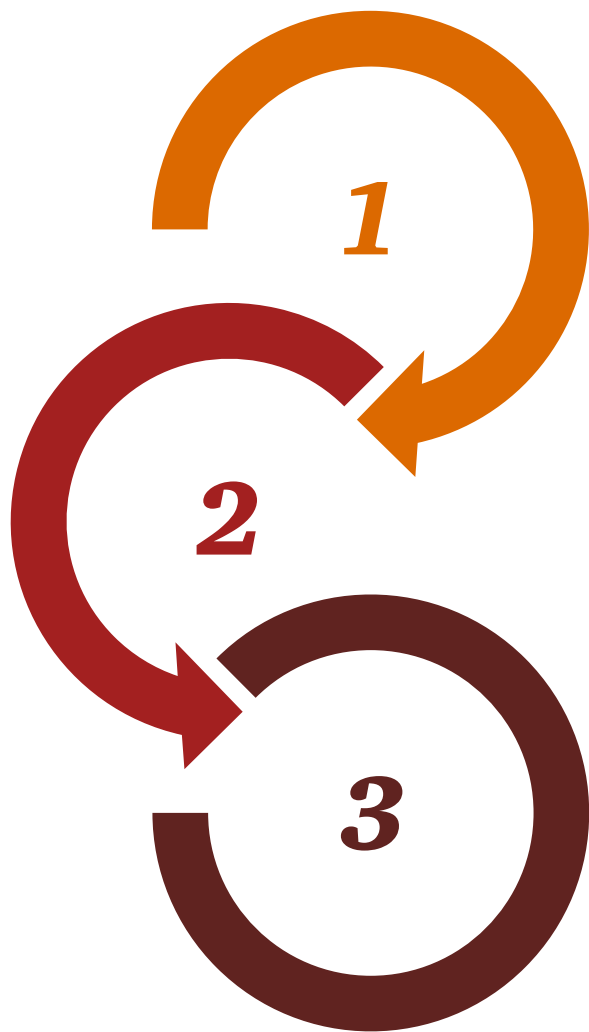
### PwC observation

*The new requirements will provide more flexibility, and allow entities to apply hedge accounting where they would not be able to do so under the current MFRS 139 requirements. As a result, this is an opportunity for corporate treasurers and boards to review their current hedging strategies and accounting, and to consider whether they continue to be optimal in view of the new accounting regime.*



#### Panel 4 - Some notable changes in hedge accounting

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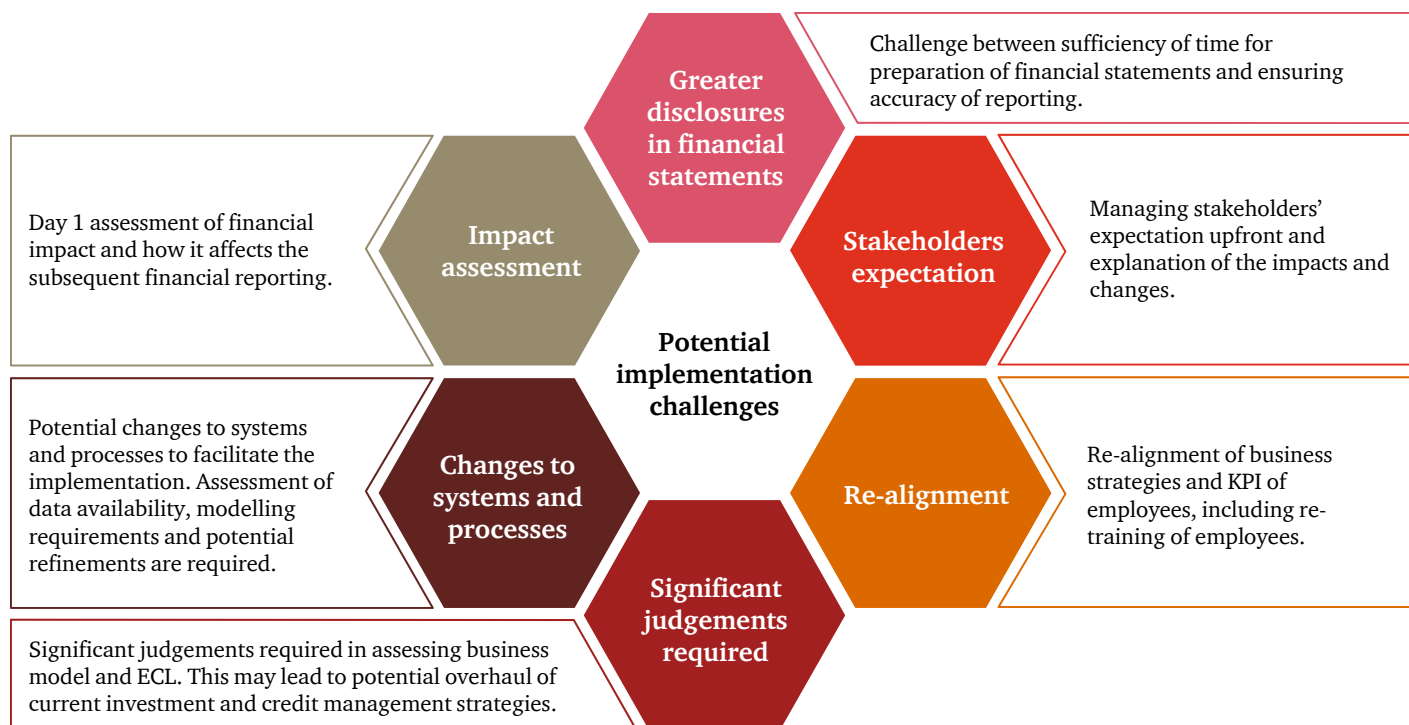
- MFRS 9 relaxes the requirements for testing the hedge effectiveness. Under MFRS 139, a hedge must be highly effective, both going forward and in the past (that is, a prospective and retrospective test, with results in the range of 80%-125%). MFRS 9 replaces this bright line test with a requirement to establish an economic relationship between the hedged item and hedging instrument, and for the hedged ratio to be the same as the one that the entity actually uses for risk management purposes.
  - Hedge ineffectiveness continues to be reported in profit or loss.
- 
- Risk components of non-financial items can be designated as hedged items under MFRS 9, provided they are separately identifiable and reliably measureable.
  - This is good news for entities that hedge only a component of the overall price of non-financial items (such as the oil price component of jet fuel price exposure). It is likely that more hedges will qualify for hedge accounting under MFRS 9.
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- Treasurers commonly group similar risk exposures and hedge only the net position (e.g. the net of forecast purchases and sales in a foreign currency).
  - MFRS 9 now allows such a net position to be designated as the hedged item provided it is consistent with the entity's risk management strategy. However, this is only available for foreign currency hedges.
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## Implementation challenges

As entities draw nearer to the effective date of MFRS 9, there will be anxiety and concern over the smooth and successful implementation of the standard. The degree of impact to each entity will vary depending on the type and complexity of the financial instruments held and whether changes to current systems and processes are required.

Entities are therefore encouraged to prepare itself earlier towards a smooth implementation of MFRS 9.

*Some of the potential implementation challenges include:*





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## Let's talk



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