MALAYSIAN INSTITUTE OF ACCOUNTANTS

FREQUENTLY-ASKED QUESTIONS (FAQs) FOR MFRS 9 *FINANCIAL INSTRUMENTS*

MFRS 9 *Financial Instruments* was issued by the Malaysian Accounting Standards Board on 17 November 2014. MFRS 9 is effective for financial period beginning on or after 1 January 2018 with early application permitted.

As part of FRSIC initiative to assist preparers to implement MFRS 9, FRSIC via its sub-group, FRSIC Financial Services Task Force (FRSIC-FSTF) has established 3 work streams to identify MFRS 9 implementation issues. These work streams involve the participation of preparers, auditors and regulators.

Compiled in these FAQs are some of the implementation issues that the staff of the Institute received which have been discussed by the work streams. The discussion points and conclusions to the questions have been prepared by the staff of the Institute and are not necessarily the views of the Institute.

Auditors and preparers are expected to use professional judgement in determining if the questions and conclusions are both appropriate and relevant to their circumstances.

Introduction

MFRS 9 establishes the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. This Standard replaces MFRS 139 *Financial Instruments: Recognition and Measurement.*

The following are major changes introduced in MFRS 9:

1. **Classification and measurement of financial assets and liabilities**

   MFRS 9 requires an entity to classify its financial assets based on the business models within which they are held as well as their contractual cash flow characteristic. In relation to classification and measurement of financial liabilities, in cases where fair value option is applied, MFRS 9 requires the fair value change due to entity's own credit to be recorded in other comprehensive income rather than in profit or loss, unless this creates an accounting mismatch.

2. **Impairment methodology**

   MFRS 9 replaces the 'incurred losses model' in MFRS 139 with the 'expected credit losses model'. Under the expected credit losses model, an entity is required to recognise loss allowance for a financial instrument at an amount equal to the *12-month expected credit losses* or *lifetime expected credit losses*. Impairment methodology introduces under MFRS 9 also emphasises on forward-looking information to reflect instruments' expected credit losses.

3. **Hedge accounting**

   MFRS 9 aligns hedge accounting more closely with risk management, establishes a more principle-based approach to hedge accounting and addresses inconsistencies and weaknesses in the hedge accounting model in MFRS 139.

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CLASSIFICATION, RECOGNITION AND DERECOGNITION

Q1. Bank Negara Malaysia (BNM)'s policy document on Capital Adequacy Framework (Capital Components) requires the principal terms and conditions of regulatory capital instrument to include non-viability clauses, which provide BNM the full discretion to decide on whether to require the regulatory capital instrument to be written-off or converted into ordinary shares when:

(a) the financial institution or financial group has ceased or is about to cease to be viable; or

(b) a capital injection or equivalent capital support has been provided to the financial institution, without which the financial institution would cease to be viable.

Such non-viability clauses are to ensure loss absorbency at the point of non-viability.

Since the non-viability clauses are included in the principal terms and conditions, will these contractual terms result in the financial instruments failing the SPPI test?

Paragraph 4.1.2 of MFRS 9 states that "A financial asset shall be measured at amortised cost if both of the following conditions are met:

(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and

(b) 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."

It was further explained in paragraph 4.1.3(b) that interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin.

Instrument E in paragraph B4.1.13 illustrates the following:

Instrument E is issued by a regulated bank and has a stated maturity date. The instrument pays a fixed interest rate and all contractual cash flows are nondiscretionary. However, the issuer is subject to legislation that permits or requires a national resolving authority to impose losses on holders of particular instruments, including Instrument E, in particular circumstances. For example, the national resolving authority has the power to write down the par amount of Instrument E or to convert it into a fixed number of the issuer's ordinary shares if the national resolving authority determines that the issuer is having severe financial difficulties, needs additional regulatory capital or is 'failing'.	The holder would analyse the contractual terms of the financial instrument to determine whether they give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding and thus are consistent with a basic lending arrangement. That analysis would not consider the payments that arise only as a result of the national resolving authority's power to impose losses on the holders of Instrument E. That is because that power, and the resulting payments, are not contractual terms of the financial instrument. In contrast, the contractual cash flows would not be solely payments of principal and interest on the principal amount outstanding if the contractual terms of the financial instrument permit or require the issuer or another entity to impose losses on the holder

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	(eg by writing down the par amount or by converting the instrument into a fixed number of the issuer's ordinary shares) as long as those contractual terms are genuine, even if the probability is remote that such a loss will be imposed.

It is observed that the non-viability clauses embedded in the contractual terms arise only as a result of BNM's regulatory requirement for an instrument to qualify as a regulatory capital. It is also noted that−

(a) Only BNM (not the issuer or investor) has the power to trigger the non-viability clauses in accordance with provisions under the capital adequacy rules; and
(b) Should BNM's capital adequacy rules were to be amended in the future such as the non-viability clauses were no longer a regulatory requirement, then the non-viability clauses would immediately cease to apply.

Based on the above observations, the non-viability clauses embedded in the contractual terms are in substance a regulatory requirement, and hence, should not be considered in the analysis of the contractual payment features of the instrument.

The above conclusion is only applicable to capital instruments issued in Malaysia which are subject to the Malaysian law and regulations.

Q2. Sustainable Responsible Investment (SRI) Sukuk is introduced to promote socially responsible financing and investment under the Securities Commission's Capital Market Masterplan 2. SRI Sukuk is similar to existing Sukuk with additional emphasis on the non-financial Key Performance Indicators (KPIs) such as the number of schools selected and the number of teachers and senior leadership that achieved the required rating. In a situation where the KPIs are met, the SRI Sukuk agreement states that investors will waive a portion of the principal and/or interest.

Does SRI Sukuk meet the SPPI test?

Paragraph 4.1.3 of MFRS 9 explained that:
(a) principal is the fair value of the financial asset at initial recognition.
(b) interest consists of consideration for the time value of money, for credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin.

It is further explained in paragraph B4.1.7A of MFRS 9 that contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money (see paragraphs B4.1.9A–B4.1.9E) and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example,

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the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.

Based on available SRI sukuk in the Malaysian market, it was observed that the contractual cash flows in SRI sukuk varies significantly based on the achievement of the KPIs, and thus, create exposure or volatility that is unrelated to a basic lending arrangement as explained in paragraph B4.1.7A of MFRS 9. As such, where the contractual cash flows of the SRI sukuk are not of a basic lending arrangement, an entity shall measure the instrument at fair value through profit or loss. The measurement of the fair value shall be made based on guidance provided in MFRS 13 *Fair Value Measurement*.

Q3. BNM's policy document on Credit Card requires the issuer to allocate payments received from cardholders to settle the balances according to their interest rates, with items attracting the highest interest rate paid first. The policy further specify that finance charges shall not be imposed on the portion of balances that relates to finance charges and other fees that were carried forward from the previous statement.

Based on the requirements above, does credit card portfolio meet the SPPI test?

Paragraph B4.1.7A of MFRS 9 explained that contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money (see paragraphs B4.1.9A–B4.1.9E) and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.

An entity needs to assess whether the net return from such portfolio is within the reasonable range of basic lending arrangement and hence, would pass the SPPI test. If the net return falls outside the reasonable range of basic lending arrangement, such instrument would fail the SPPI test.

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Issuers are encouraged to continue to monitor the net return from credit card portfolio to ensure the net return continues to be within the reasonable range of basic lending arrangement and hence, able to pass the SPPI test.

MEASUREMENT

IMPAIRMENT

Q4. Paragraph 5.5.1 of MFRS 9 requires an entity to recognise a loss allowance for expected credit losses on a financial asset that is measured at amortised costs or fair value through other comprehensive income, a lease receivable, a contract asset or a loan commitment and a financial guarantee contract.

Does an entity need to apply the impairment requirements for accrued interest receivables on financial asset measured at fair value through profit or loss?

Paragraph 5.2.1 of MFRS 9 states that an entity shall apply the impairment requirements in Section 5.5 to financial assets that are measured at amortised cost in accordance with paragraph 4.1.2 and to financial assets that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A. As such, the standard is clear that the impairment requirements in Section 5.5 of MFRS 9 only applies to financial assets that are measured at amortised cost and to financial assets that are measured at fair value through other comprehensive income. For financial assets that are measured at fair value through profit or loss, the fair value movement has incorporated the consideration for the impairment on the accrued interest portion. As such, an entity does not need to consider impairment requirement separately from the fair value as at reporting date,

Q5. A lessee may have the option to terminate a lease contract entered with a lessor in a lease arrangement. Does an entity need to incorporate the probability of cancellation of a lease contract by a lessee in calculating the expected credit losses?

Paragraph 2.1(b)(i) states that MFRS 9 does not apply for rights and obligations under leases to which MFRS 117 applies. However, it requires that lease receivables recognised by a lessor are subject to derecognition and impairment requirements of MFRS 9.

Paragraph 5.5.19 of MFRS 9 deals with the maximum period to consider when measuring expected credit losses. The paragraph states that the maximum period to consider is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice. However, as explained in paragraph B5.5.51 of MFRS 9, an entity shall consider all reasonable and supportable information that is relevant to the estimate of expected credit losses, including the effect of expected prepayments.

The scenario above is similar to the early redemption of financial liability by lessee on the lease contract. Paragraph B5.5.34 states that when measuring a loss allowance for a lease receivable, the cash flows used for determining the expected credit losses should be consistent with the cash flows used in measuring the lease receivable. As such, when lessee has an

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option to cancel the lease contract, an entity shall take into consideration the expected prepayments from the lessee in the cash flow estimation for the purpose of measuring the expected credit losses.

To illustrate, a lessor and a lessee entered into a 10-year lease contract with an option for the lessee to terminate the lease any time after 4 years. If 4 years' lease repayments were used in determining the carrying amount of the lease, then the same assumption has to be used to determine the prepayment or cancelation probability.

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