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 will be 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 consist of preparers, auditors and regulators.

Compiled in this 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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SCOPE

Q1. Paragraph 5.5.1 of MFRS 9 states that an entity shall recognise a loss allowance for expected credit losses on a financial asset that is measured in accordance with paragraphs 4.1.2 or 4.1.2A, a lease receivable, a contract asset or a loan commitment and a financial guarantee contract to which the impairment requirements apply in accordance with paragraph 2.1(g), 4.2.1(c) or 4.2.1(d).

Is performance guarantee included under the scope of MFRS 9, similar to financial guarantee contract?

Financial guarantee contract ("FGC") is defined as a contract that requires issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument [refer to Appendix A of MFRS 9].

The subject matter of a performance guarantee, in general, is an action (or service) required to be 'performed' by the obligor. Although a performance guarantee may eventually result in an amount (i.e. monetary compensation) to be paid by the guarantor if the obligor failed to perform the action or service as required, such a payment obligation or a debt will only be created/crystallised upon the failure to perform the action or service.

Importantly, an entity shall assess a guarantee based on its specific terms, conditions and obligations to determine whether the guarantee links to performance of an action or debt instrument. If the guarantee links to the performance of an action or a service, the related obligation shall be scoped out from MFRS 9. On the other hand, if the guarantee links to a debt instrument, it meets the definition of a FGC and shall be within the scope of MFRS 9. However, if an entity has previously asserted explicitly that it regards FGC as insurance contracts and has used accounting that is applicable to insurance contracts, the entity may elect to apply MFRS 4 *Insurance Contracts* to such FGC.

CLASSIFICATION, RECOGNITION AND DERECOGNITION

Q2. A Musyarakah contract includes a loss sharing feature whereby the contractual terms link principal and profit payment to the profitability of the Musyarakah venture. This also means that there would be some element of risks or volatility in the contractual cash flows that may be inconsistent with basic lending principle.

As such, are the cash flows arising from a Musyarakah contract meeting the definition of 'solely payment of principle and interest' (SPPI)?

MFRS 9 states the following:

- 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

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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.

Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions [refer to paragraph 4.1.2].

- A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:
  a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets, 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.

  Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions [refer to paragraph 4.1.2A].

- For the purpose of applying paragraphs 4.1.2(b) and 4.1.2A(b):
  a) principal is the fair value of the financial asset at initial recognition. Paragraph B4.1.7B provides additional guidance on the meaning of principal.
  b) 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. Paragraphs B4.1.7A and B4.1.9A–B4.1.9E provide additional guidance on the meaning of interest, including the meaning of the time value of money [refer to paragraph 4.1.3].

It was observed that a Musyarakah contract takes on the form of a joint venture whereby parties to Musyarakah contract (i.e. Musyarakah partners) could share risks and rewards of the venture. If this is the case, the investor would assume more than credit risk. This means if the joint venture is making losses, the investor would have to bear/assume its share of losses and on the other hand if the joint venture is making profits, the investor would share the benefits. As such, cash flows from this Musyarakah contract would not meet the definition of principal and interest as stipulated in paragraph 4.1.3 above.

But an entity needs to perform a thorough assessment on the contractual terms and conditions of a Musyarakah contract to determine whether their effects on the contractual cash flows are more of a basic lending arrangement or an investment in a joint venture. If the contractual terms and conditions of the Musyarakah contract are those of a basic lending arrangement, especially if the terms include Wa'd (promise to purchase from other partner), it may pass the SPPI test. This assessment may include an analysis to determine that any profit and/or loss sharing feature is “not genuine” or could have only a “de minimis” effect on the contractual cash flow of the Musyarakah contract and thus would not cause the contract to fail the SPPI test [refer to paragraph B4.1.18].

Q3. Entity A enters into a contractual arrangement with its subsidiary to provide an intra-group loan to finance a specific project undertaken by the subsidiary. Assuming that the intra-group loan falls within the scope of MFRS 9, how should Entity A determine whether the intra-group loan passes the SPPI test?

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Paragraph B4.1.7 of MFRS 9 states that entity requires to classify a financial asset on the basis of its contractual cash flow characteristics. To do so, an entity needs to determine whether the financial asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding ("SPPI").

When performing SPPI test, the fact that a contractual arrangement is entered into with a related party does not negate the need to assess the effects of the contractual cash flows based on the contractual terms therein. Nevertheless, additional analysis may be required to determine the effect of the contractual terms and conditions on the contractual cash flows. The following factors may indicate that the contractual cash flows of an intra-group loan to finance a specific project are SPPI:

- There is a loan or funding agreement with appropriate terms that commensurate the risks involved (e.g. interests to be charged are determined by the Treasury function after considering funding costs, repayment capability of the related party and timing, locations of the project and local financial market environment etc.) – the contractual terms are those of a normal lending arrangement with contractual obligation to pay back the loaned amount and the lender will be compensated for any delay in payments and repayments etc.

- Governance is in place where the entity and its immediate or penultimate parents etc. within the same group/sub-group is expected to endeavor to pay back the loan as per the agreement signed. The entities involved are expected to endeavor to enforce and comply with the contractual terms and conditions as agreed and documented within the governance process although legal actions may be unlikely.

- It is clear from the terms and conditions of the loan agreement that the lender will not enjoy any 'upside' from the business venture or project financed, and will not be required to bear any loss from the business venture contractually. The lender has the contractual rights to recover the amount lent including taking over any assets available under the project, and any excess after recovering the loan amount plus interests due must be returned to the borrowing entity.

MEASUREMENT

IMPAIRMENT

Q4. How should an entity determine loss given default (LGD) relating to government securities and deposits or placement with financial institutions in Malaysia? How should the LGD be applied at group level for an entity in multi-location?

MFRS 9 defines expected credit loss as the weighted average of credit losses with the respective risks of default occurring as the weights [refer to Appendix A of MFRS 9]. MFRS 9 further requires an entity to assess the credit risk of the counter-party to determine expected credit losses and it includes counter-party's probability of default and loss given default.

Credit risk is defined as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation [refer to Appendix A of MFRS 7 *Financial Instruments: Disclosures*]. It is important to note that any entity has a chance to default including a government. As such, the probability of default shall not be zero.

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For LGD purpose, careful consideration and assessment shall be undertaken to assess the lender's ability to recover defaulted amounts and the debtor's commitment and capability to still honour its repayment obligation under distress situation. This shall include assessing historical and track records of the debtor.

For instance, the LGD assessment involving a government as the counterparty shall include among others, country risk rating, public debt ratios, public funding and financial market structure, monetary policy, fiscal policy and their executions by the government in the past and foreseeable future etc. The LGD assessment involving a local financial institution shall also include regulatory and supervisory environment the institution is subjected to in the past and foreseeable future.

Applying the principle above, the following scenarios illustrate the LGD assessment for government securities and deposits or placement with financial institutions in Malaysia:

Scenario	LGD assessment
Scenario 1: An entity invests in Malaysian Ringgit denominated debt securities issued by federal government of Malaysia. Scenario 2: An entity invests in Malaysian Ringgit denominated private debt instruments guaranteed by federal government of Malaysia.	Zero LGD as past track records indicate that no investors have suffered any losses from Malaysian Ringgit denominated debt instruments issued or guaranteed by the federal government of Malaysia. These track records are expected to maintain in the foreseeable future in view of the existing monetary, fiscal and financial market policies and regulatory and supervisory environment.
Scenario 3: An entity has Malaysian Ringgit denominated deposits or placements with Malaysian financial institutions regulated and supervised by Bank Negara Malaysia.	LGD rate shall be based on lender's ability to recover defaulted amounts and obligor's commitment and capability to honour its repayment obligation under distress situation, as can be indicated in historical track records and if the track records are expected to maintain in the foreseeable future. The level of uncertainty will increase when a judgement is exercised as to the expected market condition and environment into a more distant future. On the other hand, there would be more certainty if the above assessment and judgement is in relation to near future, e.g. assessment about deposits and placements with financial institutions with short maturity and which are expected to be withdrawn for

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	use within a short period of time after balance sheet date.
Scenario 4: An entity invests in foreign currency denominated securities issued by federal government of Malaysia.	LGD rate shall be based on lender's ability to recover defaulted amounts and obligor's commitment and capability to honour its repayment obligation under distress situation, including the obligor's ability to obtain sufficient foreign currency for repayment, as can be indicated in historical track records and if the track records are expected to maintain in the foreseeable future. Judgement should be made as to the likelihood of the past track records to repeat in the foreseeable future including the reporting entity's expectation on the obligor's, financial market, regulatory and supervisory conditions and environment.
Scenario 5: An entity invests in foreign currency denominated securities guaranteed by federal government of Malaysia.	
Scenario 6: An entity has foreign currency denominated deposits or placements with Malaysian financial institutions.	
Scenario 7: An entity has foreign currency denominated deposits or placements with financial institutions in other jurisdictions.	

Notwithstanding the views above, conclusions arrived at by the reporting entity will need to be revisited at least annually and as and when new information is available.

It is also important for a group with multi-location entities to perform a robust assessment of other factors affecting LGD (e.g. country transfer risk) before assigning a similar LGD to similar instrument issued by the same counterparty held by its subsidiaries in other locations outside Malaysia.

The following example illustrates how LGD is applied for a group with multi-location entities:

A Malaysian bank (Bank F) has a subsidiary in Country X where the subsidiary placed a deposit amounting to RM2 million with Bank G, also a Malaysian bank. For Country X local reporting purpose, the subsidiary has assigned 20% LGD for its deposit with Bank G. However, in the Bank F's consolidated financial statements, Bank F ***may*** *reassign the LGD for the deposit placed by the subsidiary in Bank G to reflect the group's assessment of assigning zero LGD for deposits with financial institutions in Malaysia, provided that it has determined that no other factors affecting the LGD.*

Q5. It is common for parent companies to provide intragroup loans to its subsidiaries. These loans may vary in terms and conditions. Most of the time the loans are advanced on favourable terms (often interest free).

Can an entity measure the expected credit losses for interest-free intragroup loans that are repayable on demand using simplified approach?

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The general approach in MFRS 9 requires an entity to measure expected credit loss at an amount equal to the lifetime expected credit loss if the credit risk on the financial instrument has increased significantly since initial recognition [refer to paragraph 5.5.3]. Otherwise, an entity shall measure expected credit loss of the financial instrument at an amount equal to 12-month expected credit loss [refer to paragraph 5.5.5].

MFRS 9 also introduces simplified approach for trade receivables or contract assets that result from transactions that are within the scope of MFRS 15 *Revenue from Contracts with Customers*, where an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for trade receivables and contract assets that do not contain significant financing component in accordance with MFRS 15 [refer to paragraph 5.5.15(a)(i)] e.g. those that are short term in nature and expected to be settled within 12 months. For trade receivables that contain a significant financing component, MFRS 9 [refer to paragraph 5.5.15(a)(ii)] gives an entity an option, as its accounting policy, to measure the loss allowance at an amount equal to the lifetime expected credit losses.

As intragroup loans (lending) to related parties are not transactions arising from contracts with customers within the scope of MFRS 15, accordingly, the expected credit loss should be determined using the general approach rather than the simplified approach. Nevertheless, if the intra-group loans are short term in nature and due within 12 months, the lifetime expected credit losses will not be materially different from a 12-month expected losses due to their short lifetime.

The requirements relating to effective interest rate of an intra-group loan, including those with interest-free, have not changed in MFRS 9 from the previous standard i.e. MFRS 139. The same requirements and considerations applied in MFRS 139 shall continue and be carried forward to MFRS 9.

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