

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 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.

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

SCOPE

- Q1. It is common for parent companies and their subsidiaries to enter into intra-group loans. These loans may vary in terms and conditions. Most of the time, the loans are advanced on favourable terms (often interest free). Some of the loans have no written terms (i.e. no interest and fixed repayment terms).**

For intra-group loans with no written terms, where repayment is not expected in the foreseeable future, are these financial assets in the scope of MFRS 9 or should they be accounted for as part of the net investment in subsidiary by the parent in its separate financial statements (i.e. within the scope of MFRS 127 *Separate Financial Statements*)?

Intra-group loans with written terms would generally fall under the scope of MFRS 9 where loans are recognised at fair value on initial recognition based on the market rate of interest for similar loans. All requirements of MFRS 9 will therefore be applicable, including impairment.

However, intra-group loans with no written terms are judgmental and require assessment of the economic substance of such loans. These loans may not be within the scope of MFRS 9 if in substance, such loans reflect long-term capital injection rather than normal operational funding such as payment of expenses made on behalf. As such, an entity needs to assess the nature of such intra-group loans, including past practice and payment pattern of such loans. If such loans are determined to be a capital injection, different measurement and impairment requirements apply to it, which are not governed under MFRS 9. Where the loan is a capital injection from parent companies to subsidiaries, it falls under the scope of MFRS 127.

[Question 2 was inserted on 7 March 2018]

- Q2. 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

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

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

Q3. Paragraph 4.1.2 provides that a financial asset shall be measured at amortised cost if it is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and the contractual terms of the financial assets are solely payments of principal and interest on the principal amount outstanding. Paragraph B4.1.3B further explains that sales that occur may be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows if such sales are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent).

How can it be determined whether such sales are ‘infrequent’ or ‘insignificant in value’?

Paragraph 4.1.1 emphasises that an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of:

1. The entity’s business model for managing the financial assets; and
2. The contractual cash flow characteristics of the 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. Hence, it does not depend on management’s intentions for an individual instrument – i.e. portfolio rather than instrument-by-instrument basis.

MFRS 9 clarifies that the entity’s business model determines whether cash flow will result from collecting contractual cash flows, selling financial assets or both. Information about past sales and expectations about future sales provide evidence related to how the entity’s stated objective for managing financial assets is achieved and, specifically, how cash flows are realised [refer paragraph B4.1.2C]. This includes:

- (a) How the performance of the business model and the financial assets held are evaluated and reported;
- (b) The risks that affect the performance of the business model and the way which those risks are managed; and
- (c) How managers of the business are compensated (i.e. whether based on the fair value of the asset managed or the contractual cash flows collected). [refer paragraph B4.1.2B]

Sales in themselves do not determine the business model and therefore cannot be considered in isolation. There is no bright line in order to assess whether sales are ‘infrequent’ or ‘insignificant in value’. An entity will need to use judgment, based on facts and circumstances when making such assessment. It is important to understand the reasons for those sales and whether such sales are consistent with the entity’s hold to collect business model.

Using the principle outlined above, determination of whether sales are ‘infrequent’ or ‘insignificant in value’ shall be made, for instance:

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

- (a) To compare the sales value against the value of the portfolio that is subject to business model assessment;
- (b) To compare expected sales over the expected lives or average lives of the instruments in the portfolio;
- (c) To assess the reason(s) of the sales, for e.g. to manage credit risk of the portfolio or an individual asset or as part of recovery process etc.

Q4. Depending on contractual terms, perpetual instruments may or may not meet the definition of equity as defined in MFRS 132 *Financial Instruments: Presentation*. How would this impact classification when the holders account for the asset under MFRS 9?

An entity shall assess whether its investment in perpetual instrument meets the definition of an equity instrument or debt instrument in MFRS 132. If such an instrument is determined to be an equity instrument, MFRS 9 requires the instrument to be carried at fair value with changes in fair value to be recognised in profit or loss, unless an entity makes an irrevocable election at initial recognition to present changes in fair value in other comprehensive income without recycling to profit or loss [refer paragraph 4.1.4].

On the other hand, if the investment in a perpetual instrument is a debt instrument in accordance with its specific terms and conditions, an entity shall assess whether such instrument shall be measured at amortised cost or at fair value through other comprehensive income or at fair value through profit or loss, based on the entity's business model for managing the instrument and contractual cash flow characteristics of the instrument [refer to paragraphs 4.1.2 and 4.1.2A].

Q5. Trade receivables held by corporates are often subject to factoring arrangements. Depending on the terms and conditions, a factoring may or may not result in derecognition of the trade receivables. Is the “sale” referred to in the business model assessment under MFRS 9 equivalent to “derecognition” under MFRS 9? Are sales considered to have taken place when the trade receivables are transferred under factoring agreements and accordingly, qualify for derecognition in its entirety?

Paragraph 3.2.2 requires an entity to determine whether derecognition should be applied to a part of a financial asset (or a part of a group of similar financial asset) or a financial asset (or a group of similar financial asset) in its entirety.

Paragraph 3.2.3 further states that an entity shall derecognise a financial asset when, and only when:

- (a) The contractual rights to the cash flows from the financial asset expire; or
- (b) It transfers the financial asset and the transfer qualifies for derecognition.

As such, if the factoring arrangement meets the criteria above, the trade receivables shall be derecognised and sales can be considered to have taken place. Conversely, if the factoring arrangement does not meet the criteria above, such as when an entity provides guarantee on the recoverability of trade receivables, the trade receivables shall not be derecognised as the entity still retains substantially all the risks and rewards of ownership. Accordingly, there is no sale.

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

- Q6. Companies may have set up a master factoring agreement with a bank which resulted in the trade receivables transferred meeting the derecognition criteria in MFRS 9. However, at the inception of a trade receivable, it is often unknown whether it will be subject to factoring. Such a decision is normally made later in the process. In such circumstances, what would be the applicable business model for the trade receivables?**

Paragraph 4.1.1 emphasises that an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of:

1. The entity's business model for managing the financial assets; and
2. The contractual cash flow characteristics of the financial assets.

An entity needs to consider whether the trade receivables still meet the business model whose objective is to hold financial assets in order to collect contractual cash flows. Among others, an entity shall assess the intention and reason of the factoring arrangement. Paragraph B4.1.3 clarifies that although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus, an entity's business model can be to hold financial assets to collect contractual cash flows even when the sales of financial assets occur or are expected to occur in the future.

For instance, if the factoring arrangement is entered when there is an increase in the assets' credit risk or to manage credit concentration risk, the business model may still be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows. Likewise, if an entity has committed to factoring arrangement with regard to its trade receivables, regardless of whether there is an increase in an asset's credit risk or credit concentration risk, it may be an indicator that the entity's business model is not to hold such asset in order to collect contractual cash flows.

Based on the objectives and reasons of factoring arrangement, an entity may need to further segregate or segmentise its trade receivables into different portfolio in order to reflect the level at which an entity manages those trade receivables. For instance, those "pre-qualified" trade receivables will be classified as one portfolio carried at fair value while other trade receivables will be classified in another portfolio carried at amortised cost.

[Questions 7 and 8 were inserted on 7 March 2018]

- Q7. 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:

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

- 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.

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].

- Q8. 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?**

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

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.

[Questions 9, 10 and 11 were inserted on 1 August 2018]

- Q9. 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?

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

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 (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

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

- (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.

Q10. 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, 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

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

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*.

- Q11. 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.

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

SUBSEQUENT MEASUREMENT

- Q12. Paragraph 46(c) of MFRS 139 *Financial Instruments: Recognition and Measurement* allows an entity to measure its investment in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured at cost. However, under MFRS 9, an entity is required to measure its investment in equity instruments at fair value through other comprehensive income or fair value through profit or loss. How does an entity derive the fair value of such an investment?**

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

MFRS 9 requires an entity to measure equity instruments at fair value. Fair value measurement approach is governed under MFRS 13 *Fair Value Measurement* where it introduces three widely used valuation techniques which are market approach, cost approach and income approach. Fair value of equity instruments that do not have a quoted market price in an active market will largely depend on other observable and unobservable inputs.

It should also be noted that paragraph B5.2.3 states that in limited circumstances, cost may be an appropriate estimate of fair value such as if insufficient more recent information is available to measure fair value or if there is a wide range of possible fair value measurements and cost represents the best estimates of fair value within that range. Paragraph B5.2.4 further states the list of indicators that cost might not be representative of fair value, although it is not exhaustive:

- (a) a significant change in the performance of the investee compared with budgets, plans or milestones.
- (b) changes in expectation that the investee's technical product milestones will be achieved.
- (c) a significant change in the market for the investee's equity or its products or potential products.
- (d) a significant change in the global economy or the economic environment in which the investee operates.
- (e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.
- (f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.
- (g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

In practice, it is common for entities to measure or estimate fair value of unquoted equity investment based on a multiple of net tangible assets (NTA) or a multiple of net assets (NA) or adjusted NTA or adjusted NA. These methods involve deriving the fair value of an investee's equity instruments by reference to the fair value of its assets and liabilities (recognised and unrecognised) with appropriate adjustment. Such methods might be appropriate depending on the types of unquoted shares, and the nature of the business of the investee. Importantly, an entity shall ensure the fair value estimate is consistent with fair value measurement principle outlined in MFRS 13 *Fair Value Measurement*.

Entity may refer to the educational material issued by the IASB entitled "*Illustrative Examples to accompany IFRS 13 Fair Value Measurement for Unquoted Equity Instruments within the Scope of IFRS 9 Financial Instruments*" for a high level valuation guidance of unquoted equity instruments within the context of MFRS 13.

IMPAIRMENT

Q13. Does an entity's credit risk model need to be reviewed and validated?

Paragraph 5.5.4 states that the objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking. If the credit risk on a financial instrument has not increased significantly since initial recognition, the loss allowance for that financial instrument shall be measured at 12-month expected credit loss. MFRS 9, however, does not dictate the credit risk model that

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

an entity should use for such assessment. As such, an entity may apply various approaches when assessing whether the credit risk on a financial instrument has increased significantly since initial recognition or when measuring expected credit losses, including ability to apply different approaches for different instruments [refer paragraph B5.5.12].

Considering the nature of expected credit losses model that requires reasonable and supportable forward-looking information, paragraph B5.5.52 further emphasises for a regular review of the methodology and assumptions used for estimating expected credit losses to reduce any differences between estimates and actual credit loss experience. An entity shall also take into consideration whether validation is needed arising from regulator's expectation on credit risk model. Principle 5 of Basel Committee's Guidance on credit risk and accounting for expected credit losses requires banks to have policies and procedures in place to appropriately validate models used to assess and measure expected credit losses.

Q14. Retail portfolio consists of individual customer loan accounts such as personal loans, hire purchase loans and credit card loans. Individual customer's credit rating is given only on initial recognition when banks perform customer's credit assessment. Subsequent to initial recognition, individual retail accounts are generally not monitored and tracked on systematic basis (i.e. no quarter or annual review). As such, can financial institutions rely on month-in-arrears (MIA) or days past due (DPD) for transfer criteria of retail portfolio?

Paragraph 5.5.9 requires an entity to assess at each reporting date, whether the credit risk on a financial instrument has increased significantly since initial recognition. Such assessment shall take into account reasonable and supportable information (that is available without undue cost or effort), including forward-looking information. Paragraph 5.5.11 further clarifies that if reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on *past due* information when determining whether credit risk has increased significantly since initial recognition.

On the other hand, when information that is more forward-looking than past due status (either on an individual or a collective basis) is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since initial recognition. This is further clarified in paragraph B5.5.3 which states that an entity may not be able to identify significant changes in credit risk for individual financial instruments before the financial instrument becomes past due such as retail loans for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual instrument until a customer breaches the contractual terms.

It is also noted that Basel framework emphasises the use of scoring or rating model, especially for financial institutions that are on Internal Ratings-Based (IRB) approach. This preference took comfort that such model is used by financial institutions to monitor, manage and measure credit risk in their businesses (the fulfilment of 'use-test').

Consistent with the principle in MFRS 9 and Basel framework, the following scenarios illustrate the application of MIA or DPD for transfer criteria:

1. Scenario 1: An entity has a rating or scoring model and uses such model to monitor and manage its credit risk

If an entity has a rating or scoring model which incorporates forward-looking information and uses such model to monitor and manage its credit risk, such model should be used for transfer criteria. This is because reasonable and supportable forward-looking

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

information is readily available without undue cost or effort, as embedded in the entity's rating or scoring model which has been used in monitoring and managing credit risk.

2. Scenario 2: An entity has a rating or scoring model but have yet to use it to monitor and manage its credit risk

If an entity has a rating or scoring model but have not used it to monitor and manage its credit risk, MIA or DPD may be used for transfer criteria. Nevertheless, an entity should also consider to incorporate certain forward-looking information where relevant, including to further segregate retail portfolio into different risk profiles. This is because MIA or DPD in itself may not be sufficient to determine if there has been significant deterioration in credit risk and hence, should be supplemented with relevant and existing criteria used by the entity in monitoring and managing credit risk.

3. Scenario 3: An entity has a rating or scoring model but in the process of recalibrating new model

If an entity has a rating or scoring model in which it uses to monitor and manage credit risk but at the same time, in the midst of recalibrating a new model, the current model should be used for transfer criteria. This is because, the new rating or scoring model is still in the process of being recalibrated and would still be subjected to validation before being put in use for monitoring and managing credit risk.

Q15. How do we determine what is reasonable and supportable forward-looking information when measuring ECL?

Paragraph B5.5.49 emphasises that reasonable and supportable information is that which is reasonably available at the reporting date without undue cost or effort. Paragraph B5.5.51 further provides that an entity shall only consider all reasonable and supportable information that is relevant to the estimate of expected credit losses. As expected credit losses reflect the entity's own expectation of credit losses, the estimates shall be based on information that entity normally uses for credit management [refer paragraph B5.5.17(o)]. The entity is expected to be able to explain on how it arrives at its estimation, based on reasonable and supportable information. The expected credit losses (ECLs), by their nature, need to be updated frequently based on information available at the reporting date and can be reasonably assessed [refer paragraph B5.5.49]

In achieving the principle of measuring ECLs by considering all reasonable and supportable information, including that which is forward-looking, an entity may consider the following approach to determine such information:

- (a) Forward-looking information that are currently used by management in their business; including in credit risk management;
- (b) Forward-looking information that are currently being used by peers for similar financial instruments (or a group of financial instruments);
- (c) Other forward-looking information that are available in the market and industry and which are commonly used or referred to.

Q16. How should an entity deal with information that are available subsequent to the reporting date but before the issuance of the financial statements? Should it be included in the measurement of expected credit losses?

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

MFRS 9 does not specifically require information that are available subsequent to the reporting date to be included in the measurement of expected credit losses. However, an entity shall also consider requirements in MFRS 110 *Events after the Reporting Period* regarding the treatment of events that occur or information that are available, including forward-looking information, between the end of the reporting period and the date when the financial statements are authorised for issue.

Q17. For share margin financing, one of the common staging criteria is based on equity-to-loan of financing ratio (collateral coverage). In view that the share price is based on the quoted market price as of reporting date, is an entity required to perform projection on the share price in order to comply with forward-looking information requirement under MFRS 9?

Equity-to-loan or financing ratio (or collateral coverage) is commonly used by banks in determining staging of assets and measuring expected credit losses. The movement in collateral coverage is highly dependent on market prices of the underlying quoted shares, i.e. the collateral in the share margin financing. Share prices of listed companies reflect among others volatility in the market, current and future expected economic conditions and performances of the investee companies from market participants' perspective. Taking into consideration that the share prices of listed companies have included forward-looking information, as reflected by the market forces in determining the market prices and the price fluctuations, an entity need not perform projection on the share prices.

However, in certain circumstances, an entity may consider that a haircut is relevant and necessary, such as when the entity has doubt over the sales proceeds upon force sale of the shares.

Q18. Should forward-looking information be incorporated in probability of default (PD), loss given default (LGD) and exposure at default (EAD)?

Paragraph 5.5.4 states that the objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking.

Paragraph 5.5.17 further requires an entity to measure expected credit losses of a financial instrument in a way that reflects:

- (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- (b) the time value of money; and
- (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

In achieving the principle of the paragraphs above, an entity is expected to consider forward-looking information, where relevant, in the three components in measuring the expected credit losses, including potential effect of double-counting when it is applied to each of the three components of the PD, LGD and EAD in measuring ECLs.

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

Q19. A bank's economists would only be able to project macro-economic variables for certain number of years. Subsequent to that, should the ECL modelling revert to long run average/mean reversion method?

Paragraph B5.5.49 states that *“For the purpose of this Standard, reasonable and supportable information is that which is reasonably available at the reporting date without undue cost or effort, including information about past events, current conditions and forecasts of future economic conditions. Information that is available for financial reporting purposes is considered to be available without undue cost or effort.”*

It is further clarified in paragraph B5.5.50 that *“An entity is not required to incorporate forecasts of future conditions over the entire expected life of a financial instrument. The degree of judgement that is required to estimate expected credit losses depends on the availability of detailed information. As the forecast horizon increases, the availability of detailed information decreases and the degree of judgement required to estimate expected credit losses increases. The estimate of expected credit losses does not require a detailed estimate for periods that are far in the future—for such periods, an entity may extrapolate projections from available, detailed information.”*

Based on the guidance provided in the paragraphs above, MFRS 9 allows an entity to maximise various sources of data, both internal and external to measure expected credit losses [refer paragraph B5.5.51]. To achieve this principle, an entity shall assess whether any of the following approaches can be used to project macro-economic variables after a certain number of years:

1. Use peer group experience or long-term projection for the comparable financial instrument (or group of financial instruments)[refer paragraph B5.5.51];
2. Use past and current forecast to project a long-term average [refer paragraph B5.5.52]; or
3. Use unadjusted historical pattern assuming that the pattern will continue, depending on the nature of the historical information and when it was calculated [refer paragraph B5.5.52].

Approach 3 should be used only under limited circumstance when the entity does not or could not form a view about the future state of economy and its effects on ECLs. In most cases, an entity would be able to and would have view(s) about the future state of economy based on related and observable information.

Q20. Macro-economic variables such as House Price Index (HPI) or Property Price Index (PPI) are the relevant forward-looking information of LGD for secured loans and financing given by banks. As these macro-economic variables have been experiencing upward trends, should an entity incorporate such variables in LGD estimation, which may lead to significant write back of expected credit losses?

MFRS 9 is a principle-based standard and focuses on measurement of expected credit losses that reflects on:

- i. unbiased and probability-weighted amount;
- ii. time value of money; and
- iii. reasonable and supportable information that is available without undue cost or effort at the reporting date about past event, current conditions and forecasts of future economic conditions. [refer paragraph 5.5.17]

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

MFRS 9 also emphasises the need for an entity to incorporate variables that are specific to borrower or obligor, general economic conditions and an assessment of both current as well as future economic conditions as at the reporting date, regardless of the eventual outcome to expected credit losses amount [refer paragraph B5.5.51]. The judgement that an entity made of whether to incorporate certain variables or not, should be properly discussed, deliberated, approved, documented, revisited and reaffirmed from time to time.

The effects of these macro-economic factors should be considered in determining the LGD. While the LGD could be affected when e.g. an upward trend of collateral value is expected, the ECLs measured are required to be at point-in-time as at the reporting date.

Q21. What is the period that an entity should use to measure the expected credit losses? Can an entity select the period based on business practice?

Paragraph 5.5.19 clearly states that the maximum period to consider when measuring expected credit losses 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. Paragraph 5.5.20 however, acknowledges that some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For such financial instruments, and only those financial instruments, the entity shall measure expected credit losses over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

Q22. For investment bank business (stockbroking base), the main business activities is stockbroking services and as such, client and broker balances form the significant balance sheet items for investment bank. Clients and brokers are given certain number of days (grace period) to make settlement.

Should an entity calculate ECL for client and broker balances that are within the grace period (e.g. <T+3)?

MFRS 9 introduces an expected credit losses model where an entity shall recognise a loss allowance on a financial asset that is measured at amortised cost or fair value through other comprehensive income, a lease receivable, a contract asset or a loan or financing commitment and a financial guarantee contract. As such, clients' and brokers' balances are subjected to expected credit losses.

An investment bank provides various finance-related and other services to individuals, corporations and governments such as raising financial capital by underwriting the issuance of securities, assisting in mergers and acquisitions activities and stockbroking activities (e.g. trading equity securities or derivatives). As such, client and broker balances are considered as trade receivables of the investment bank's businesses for the services rendered.

Paragraph 5.5.15 requires an entity to measure the loss allowance at an amount equal to lifetime expected credit losses for trade receivables that result from transactions that are within the scope of MFRS 15 that do not contain a significant financing component (e.g. with short settlement period within 12 months), or if the entity makes an accounting policy choice to

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

measure the loss allowance at an amount equals to lifetime ECL for trade receivables with significant financing component.

As there can be practical challenges for preparers to gather and analyse sufficient historical data and past trends for client and broker balances within the grace period, as a practical expedient, taking into consideration the short term nature of these balances, an entity may decide to only measure and provide for lifetime ECL after the grace period (e.g. 3 days) on uncollected balances.

[Questions 20 and 21 were inserted on 7 March 2018]

Q23. 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.

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
<p><u>Scenario 1:</u> An entity invests in Malaysian Ringgit denominated debt securities issued by federal government of Malaysia.</p>	<p>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</p>
<p><u>Scenario 2:</u> An entity invests in Malaysian Ringgit denominated private debt instruments guaranteed by federal government of Malaysia.</p>	

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

	market policies and regulatory and supervisory environment.
<p><u>Scenario 3:</u> An entity has Malaysian Ringgit denominated deposits or placements with Malaysian financial institutions regulated and supervised by Bank Negara Malaysia.</p>	<p>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.</p> <p>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 use within a short period of time after balance sheet date.</p>
<p><u>Scenario 4:</u> An entity invests in foreign currency denominated securities issued by federal government of Malaysia.</p>	<p>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.</p> <p>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.</p>
<p><u>Scenario 5:</u> An entity invests in foreign currency denominated securities guaranteed by federal government of Malaysia.</p>	
<p><u>Scenario 6:</u> An entity has foreign currency denominated deposits or placements with Malaysian financial institutions.</p>	
<p><u>Scenario 7:</u> An entity has foreign currency denominated deposits or placements with financial institutions in other jurisdictions.</p>	
<p>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.</p>	

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

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.*

Q24. 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?

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.

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

[Questions 25 and 26 were inserted on 1 August 2018]

Q25. 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,

Q26. 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 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 cancellation probability.

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

HEDGE ACCOUNTING

Q27. Paragraph 7.2.21 provides entities with an accounting policy choice between applying the hedge accounting requirements of MFRS 9 (Chapter 6) or continuing to apply the existing hedge accounting requirements in MFRS 139 for all hedge accounting, pending the completion of the project on the accounting for macro hedging. Can an entity adopt Chapter 6 at its preference financial period or upon completion of the project on the accounting for macro hedging?

Existing MFRS preparers

There is no clear guidance in MFRS 9 that dictate when the Chapter 6 *Hedge Accounting* of MFRS 9 should be applied by entities. However, entities shall consider whether applying hedge accounting requirements in MFRS 9 will present more relevant and reliable information [refer paragraph 10 of MFRS 108].

Transitioning Entities

Paragraph 9 of MFRS 1 *First-time Adoption of Malaysian Financial Reporting Standards* states that the transitional provisions in other MFRSs do not apply to first-time adopter, except as specified in Appendix B - E of MFRS 1. Since Appendix B - E of MFRS 1 does not provide any exemption equivalent to paragraph 7.2.21 of MFRS 9, transitioning entities (i.e. first-time adopters) are therefore required to apply the hedge accounting requirements of MFRS 9 upon adoption of the MFRS reporting framework for financial period beginning on or after 1 January 2018, if it chooses to apply hedge accounting.