Recognizing and Measuring Financial Assets Held by Financial Institutions
(Relevant to PBE Paper I – Financial Accounting)

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Introduction

The issue of financial instruments is by far the most complicated aspect of financial reporting. Financial instruments include very simple items such as cash, accounts receivable and loans receivable, but they also include complicated financial products that involve derivatives and various hedge arrangements, such as share options, forward exchange contracts and interest rate swaps.

When reviewing the annual reports of financial institutions (such as banks) in Hong Kong, there will be certain financial instruments included in their financial statements because the industry involves many types of financial products.

The following is an extract of the total asset items in the consolidated statement of financial position for a typical bank in Hong Kong:

1. Cash and balances with banks, central banks and other financial institutions
2. Placings with and advances to banks and other financial institutions
3. Trading assets
4. Financial assets designated at fair value
5. Derivative financial instruments
6. Loans and advances to customers
7. Financial investments
8. Interest in associates
9. Investment properties
10. Property, plant and equipment
11. Intangible assets
12. Other assets

A financial instrument is defined in HKAS 32 *Financial Instruments: Presentation* as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. From the above table, you may notice that all items (except items 9–12) are financial instruments because they meet the definition of a financial instrument.

When considering the financial assets of a particular bank, you may have the following questions:
(a) How should the bank classify and recognize its financial assets?
(b) At what value should the bank measure the financial assets after initial recognition?

To answer the above questions, we must follow the guidance provided by HKFRS 9 *Financial Instruments.*

Recognition

According to HKFRS 9, financial assets are recognized in the statement of financial position when the entity becomes a party to the contractual provisions of the instrument. In other words, financial assets should be recognized when the entity becomes a party to the contact rather than when the transaction is settled. For example, suppose Alin Bank purchases Home Ltd's ordinary shares on 1 May 2017 and will settle the amount on 3 May 2017. In this case, Alin Bank should recognize its shares in Home Ltd as a financial asset on 1 May 2017 rather than on 3 May 2017.

Classification

Upon initial recognition of financial assets, HKFRS 9 requires that all financial assets be classified as either:
(a) Financial assets measured at amortized cost;
(b) Financial assets measured at fair value through other comprehensive income; or
(c) Financial assets measured at fair value through profit or loss.

This classification is made on the basis of both:
(a) the entity's business model for managing its financial assets; and
(b) the contractual cash-flow characteristics of the financial assets.

Financial assets measured at amortized cost

A financial asset is classified as measured at amortized cost if both of the following conditions are met:
(a) it is held within a business model of an entity with the objective of collecting the contractual cash flows; and
(b) the contractual terms of the financial asset give rise to cash flows on specified dates that are solely payments of principal and interest on the principal amount outstanding.

In other words, the purpose of holding such asset is to collect the contractual cash flows over the life of the instrument rather than to manage the overall return on the bank's portfolio by both holding and selling assets.

Example 1

On 1 January 2017, Alin Bank provides a three-year loan of $10 million to one of the bank's customers at an off-market interest rate of 5% (when the market rate for similar loans is 7%). The loan is held by Alin Bank for the purpose of collecting contractual interest revenue over the loan period.

In this case, Alin Bank should recognize the loan as a financial asset measured at amortized cost because the objective of Alin Bank's business model is to hold the loan in order to collect the contractual cash flows (i.e. interest revenue) over the loan period.

Financial assets measured at fair value through other comprehensive income

A financial asset is classified as measured at fair value through other comprehensive income if both of the following conditions are met:

(a) it is held within a business model of an entity with the objective of collecting the contractual cash flows and selling financial assets; and

(b) the contractual terms of the financial asset give rise to cash flows on specified dates that are solely payments of principal and interest on the principal amount outstanding.

Compared with financial assets measured at amortized cost, this business model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the business model's objective, e.g. to manage the business's everyday liquidity needs, to maintain a particular interest yield profile, or to match the duration of the financial assets to the duration of the liabilities that those assets are funding. To achieve such an objective, the entity will both collect contractual cash flows and sell financial assets.

Example 2

Alin Bank purchases 500,000 ordinary shares of Home Ltd at $73 (plus the transaction costs of $740,000) on 1 May 2017. On 31 December 2017, these shares are quoted at $75 each. The objective of holding these shares is to manage Alin Bank's daily liquidity needs and for reinvestment in higher-yield financial assets.

In this case, Alin Bank should recognize the shares in Home Ltd as financial assets measured at fair value through other comprehensive income because the objective of holding these shares is to maximize the return on the portfolio to meet everyday liquidity needs and Alin Bank achieves that objective by both collecting contractual cash flows and selling the shares.

Financial assets measured at fair value through profit or loss

A financial asset is classified as at fair value through profit or loss if it is not a financial asset measured at amortized cost or a financial asset measured at fair value through other comprehensive income.

The objective of this business model is to realize cash flows through the sale of assets. The entity makes decisions based on the assets' fair values and manages those assets to realize those fair values. In this case, the entity's objective will typically result in active buying and selling.

Example 3

Using the same information from Example 2, suppose Alin Bank holds the shares for the purpose of selling in the near term for making short-term gain.

In this case, Alin Bank should recognize the shares in Home Ltd as financial assets measured at fair value through profit or loss because they are not held to collect contractual cash flows or held both to collect contractual cash flows and to sell as financial assets. Alin Bank is primarily focused on fair-value information and uses that information to assess the investment's performance and to make decisions.

Measurement

According to HKFRS 9, upon initial recognition, all financial assets are measured at their fair value plus transaction costs, except for financial assets at fair value through profit or loss. Transaction costs are those costs that are directly attributable to the acquisition of a financial asset, including fees and commissions paid to agents, brokers and stamp duties.

The fair value of a financial asset is normally the transaction price. However, if the fair value of the financial asset at initial recognition differs from the transaction price, HKFRS 9 requires an entity to recognize the difference between the fair value at initial recognition and the transaction price as a gain or loss.

Financial assets measured at amortized cost

As required by HKFRS 9, financial assets at amortized cost should be subsequently measured at amortized cost using the effective interest method. Under the effective interest method, the *amortized cost* refers to the amount at which the financial asset is measured at initial recognition adjusted by the cumulative amortization of the premium or discount (i.e. the difference between the purchase price and the maturity amount) over the expected life of the financial asset. The effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset.

Example 4

With reference to Example 1, as the loan is classified as a financial asset measured at amortized cost, the loan should subsequently be measured at amortized cost.

In this case, since Alin Bank originates a loan that bears an off-market interest rate of 5% (the market rate for similar loans is 7%), it should recognize the loan at its fair value.

The fair value of a loan is determined by the present value of the estimated future contractual cash flows discounted at the market rate for similar loans (i.e. the effective interest rate).

Fair value $= \$500{,}000/(1 + 7\%)^1 + \$500{,}000/(1 + 7\%)^2 + \$10{,}500{,}000/(1 + 7\%)^3$
$= \$9{,}475{,}137$

Alin Bank should recognize the difference between the loan's fair value at initial recognition ($9,475,137) and the transaction price ($10 million) as a loss ($524,863).

Alin Bank's amortization table for the loan receivable is shown as follows:

Year ended 31 Dec.	Opening amortized cost	Cash flows ($10 million × 5%)	Interest revenue (7%)	Discount amortization	Closing amortized cost
	(A)	(B)	(C) = (A) × 7%	(D) = (C) – (B)	(A) + (D)
	$	$	$	$	$
2017	9,475,137	500,000	663,260	163,260	9,638,397
2018	9,638,397	500,000	674,688	174,688	9,813,085
2019	9,813,085	500,000	*686,915	186,915	10,000,000
		1,500,000		524,863	

*rounded up figure

The relevant journal entries are as follows:

	Dr. $	Cr. $
1 January 2017		
Financial assets at amortized cost – Loan receivable	9,475,137	
Profit or loss – Loss on loan	524,863	
Bank		10,000,000
Recognize the loan to a customer at fair value.		
31 December 2017		
Bank	500,000	
Financial assets at amortized cost – Loan receivable	163,260	
Interest revenue		663,260
Recognize the receipts of cash, interest revenue and amortization of loan receivable.		
31 December 2018		
Bank	500,000	
Financial assets at amortized cost – Loan receivable	174,688	
Interest revenue		674,688
Recognize the receipts of cash, interest revenue and amortization of loan receivable.		
31 December 2019		
Bank	500,000	
Financial assets at amortized cost – Loan receivable	186,915	
Interest revenue		686,915
Recognize the receipts of cash, interest revenue and amortization of loan receivable.		

31 December 2019		
Bank	10,000,000	
Financial assets at amortized cost – Loan receivable		10,000,000
Recognize the receipt of principal for loan receivable on maturity.		

Financial assets measured at fair value through other comprehensive income

For each reporting period, HKFRS 9 requires such financial assets to be measured at fair value, with all changes in fair value being recognized in other comprehensive income.

Example 5

With reference to Example 2, if Home Ltd's shares are classified as financial assets measured at fair value through other comprehensive income, the following journal entries are required:

	Dr. $'000	Cr. $'000
1 May 2017		
Financial assets at fair value through other comprehensive income (500,000 × $73 + $740,000)	37,240	
Bank		37,240
Recognize the purchase of Home Ltd's ordinary shares at fair value.		
31 December 2017		
Financial assets at fair value through other comprehensive income (500,000 × $75 – $37,240,000)	260	
Other comprehensive income – Fair value gain on financial assets measured at fair value through other comprehensive income		260
Recognize the increase in fair value of Home Ltd's ordinary shares.		

Financial assets measured at fair value through profit or loss

An entity should measure such financial assets at fair value, with all changes in fair value recognized in profit or loss.

Example 6

With reference to Example 3, if Home Ltd's shares are classified as financial assets measured at fair value through profit or loss, the following journal entries are required:

	Dr.	Cr.
	$'000	$'000
1 May 2017		
Financial assets at fair value through profit or loss (500,000 × $73)	36,500	
Profit or loss – Transaction costs	740	
Bank		37,240
Recognize the purchase of Home Ltd's ordinary shares at fair value.		
31 December 2017		
Financial assets at fair value through profit or loss (500,000 × $75 – $36,500,000)	1,000	
Profit or loss – Fair value gain on financial assets measured at profit or loss		1,000
Recognize the increase in fair value of Home Ltd's ordinary shares.		

Conclusion

Students sitting for HKIAAT PBE Paper 1 "Financial Accounting" must possess general knowledge of accounting for financial instruments. In this article, we have explained the new classification requirements for financial assets and the principles of recognition and measurement of financial assets.