HKFRS 9 Financial Instruments – derecognition and impairment
(Relevant to PBE Paper I – Financial Accounting)

Patrick P.H. Ng, BA (Hons.), M. Phil., FCPA, FCCA, Lecturer, Department of Business Administration, Hong Kong Institute of Vocational Education (Chai Wan)
Morris Y.M. Kwok, MPA, ACMA, CPA

Introduction
Financial instruments comprise one of the complex issues in PBE Paper I – Financial Accounting. In the first part of our article published in April 2012 (http://www.hkiaat.org/images/uploads/articles/PBE_PI_HKFRS9_Patrick_Morris_apr12.pdf), we explained the principles of recognition, classification and measurement of financial assets for the application of HKFRS 9. In this part, we focus on more complex areas of financial assets – derecognition and impairment.

As mentioned in the first part, HKFRS 9 "Financial Instruments" is divided into three main phases to replace HKAS 39 "Financial Instruments: Recognition and Measurement". The section "derecognition of financial assets" in HKAS 39 has been replaced in HKFRS 9. However, the guidance in HKAS 39 on impairment of financial assets continues to apply upon the completion of phase 2 of the project.

Derecognition of financial assets
HKFRS 9 defines derecognition of financial assets as the removal of a previously recognized financial asset from an entity's statement of financial position. In other words, when an entity no longer owns a financial asset, the asset should be derecognized.

HKFRS 9 sets out the conditions for the derecognition of financial assets. An entity should derecognize a financial asset when and only when:

(a) the contractual rights to the cash flows from the financial asset expire; or
(b) it transfers (e.g. sells) the financial asset and the transfer qualifies for derecognition.

Criterion (a) for derecognition of a financial asset is often easy to apply. This means if the contractual rights of an entity to the cash flows from a financial asset expire, the entity should remove this financial asset from its statement of financial position. For example, if the customer has paid off the obligation to the entity, the entity should derecognize the accounts receivable as the contractual rights to the cash flows associated with this financial asset no longer exist.

The application of criterion (b) for derecognition of a financial asset is more complex. It relies on assessment of whether the transfer qualifies for derecognition based on the extent of the transfer of the risks and rewards of ownership of the financial asset.

HKFRS 9 provides that an entity transfers a financial asset if and only if it either transfers the contractual rights to receive the cash flows of the financial asset; or it retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement.

When an entity transfers a financial asset, it should evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In other words, the financial asset has been transferred and the entity should derecognize the financial asset if it transfers substantially all the risks and rewards of ownership of the financial asset. However, if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity should continue to recognize the financial asset.

For example, a company sells an investment in shares with a call option to repurchase the shares at any time at a price equal to the shares' current market value on the date of repurchase. In this case, after the transfer of the shares, the company does not bear the risk if the share price decreases, nor does it benefit from any increase in share price. Such a transfer qualifies for derecognition since the company has transferred substantially all the risks and rewards of ownership of these shares.

When an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay those cash flows to one or more recipients, HKFRS 9 further provides that the entity should treat the transaction as a transfer of a financial asset if and only if all of the following three conditions are met:

(1) The entity has no obligation to pay amounts to the recipient(s) unless it collects equivalent amounts from the financial asset.
(2) The entity is prohibited by the terms of the transfer contract from selling or pledging the financial asset other than as security to the recipient(s) for the obligation to pay them cash flows.
(3) The entity has an obligation to remit any cash flows it collects on behalf of the recipient(s) without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the recipient(s), and interest earned on such investments is passed to the recipient(s).

Example 1

Wealth Credit Limited (WCL) is a finance company which is engaged in the provision of loans. As at 31 December 2011, WCL had an outstanding loan of $12,000,000 to Borrower B. The loan was made on 1 September 2010 for a term of two years, carries interest at 10% per annum and the interest is payable annually. On 1 September 2011, WCL entered into an arrangement with another financial institution (the FI), for the sale of the loan for $11,750,000. According to the agreement between WCL and the FI, WCL would collect the principal and accrued interest directly from Borrower B on behalf of the FI. However, WCL would be required to transfer the amount received from Borrower B to a designated bank account which would earn interest at 0.01% per day. WCL would then remit the interest earned together with the full amount of the principal and accrued interest to the FI within three days. If WCL were not able to collect the full amount of the principal and accrued interest from Borrower B, WCL would still be required to pay the amount to the FI.

Required:

Determine whether WCL should derecognize the loan to Borrower B in its financial statements for the year ended 31 December 2011.

(Modified from HKICPA QP Module A: Financial Reporting May 2007 Q3)

Solution:
In this case, WCL sells the financial asset (the loan to Borrower B) to the FI in which it retains the contractual rights to receive the cash flows (principal and accrued interest) of the loan, but assumes a contractual obligation to pay the cash flows (principal and accrued interest) to the FI.

The terms of sales agreement between WCL and the FI satisfy two conditions for the transfer of financial assets:
(1) WCL is prohibited from selling or pledging the loan to Borrower B other than as security to the FI for the obligation to pay the principal and accrued interest.
(2) WCL has an obligation to remit the amounts it collects on behalf of the FI within three days (i.e. without material delay). During these days, WCL is required to invest the amounts in a designated bank account earning interest at 0.01% per day, and interest earned on such investments is passed to the FI.

However, WCL has an obligation to pay the full amount of the principal and accrued interest to the FI even if it is unable to collect the amount due from Borrower B. Therefore, WCL cannot treat the sale of the loan to Borrower B as a transfer of financial assets and cannot derecognize the loan.

Impairment of Financial Assets
HKAS 39 recognizes the impairment of financial assets using the incurred-loss model. The incurred-loss model requires that an entity should assess at the end of each reporting period whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred if and only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a loss event) and that the loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. Objective evidence of impairment includes significant financial difficulty of the issuer, a breach of contract and bankruptcy, and adverse changes in the payment status of borrowers (e.g. an increase number of delayed payments).

If such an indication exists, the entity should determine and recognize the impairment loss. The accounting for impairment of financial assets depends on its classification.

Financial assets measured at fair value
These financial assets are not subject to testing for impairment since any decline in the fair value for such assets is recognized immediately in the profit or loss (or in other comprehensive income if so elected).

Financial assets measured at amortized cost
If there is objective evidence that such financial assets are impaired, the amount of the impairment loss is measured as the difference between the financial asset's carrying amount and present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The carrying amount of the financial asset should be reduced either directly or through use of an allowance account. The amount of the loss should be recognized in the profit or loss.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (such as an improvement in the debtor's credit rating), the previously recognized impairment loss should be reversed. The reversal should not result in a carrying amount of the financial asset that exceeds what the amortized cost would have been had the impairment not been recognized at the date the impairment is reversed. The amount of the reversal should be recognized in the profit or loss.

Below is an example illustrating the impairment of financial assets measured at amortized cost.

Example 2
World Finance Limited (WFL) is a financial institution incorporated in Hong Kong. As at 31 December 2011, WFL had made an outstanding loan of $20,000,000 to Borrower A which had severe financial difficulties.

The details of the loan were as follows:

Principal amount	$20,000,000
Original term	1 December 2008 to 30 November 2011
Original interest rate	12% per annum (compound)
Original repayment date of principal	On 30 November 2011
Original payment date of interest	On 30 November 2011

As Borrower A had not paid repaid the loan on 30 November 2011, WFL agreed to extend the credit for both the principal amount and interest due for another two years with no interest for the extended term.

Required:
Explain whether WFL should recognize an impairment loss in respect of the loan to Borrower A in its financial statements for the year ended 31 December 2011 and calculate the amount of impairment loss, if any.

(Modified from HKIPCA QP Module A: Financial Reporting May 2007 Q3)

Solution:
In this case, the default in payment of interest as well as repayment of principal at 30 November 2011 is objective evidence that the loan may be impaired.

The amount of impairment loss on the loan is measured as the difference between the loan's carrying amount and present value of estimated future cash flows discounted using the original effective interest rate of the loan.

Total outstanding principal and interest due as at 30 November 2011:
= $\$20,000,000 \times (1 + 12\%)^3$
= $28,098,560

Under the revised terms, $28,098,560 will be due on 30 November 2013. Discounting this amount at the original effective interest rate, the present value would be:

$\$28,098,560 / (1 + 12\%)^2$
= $22,400,000

Therefore, even if WFL expects that the loan and accrued interest will be fully recovered in future years according to the revised terms (i.e. there will be no future credit losses), the present value of the future cash flows is lower than the carrying amount of the loan and accrued interest at 30 November 2011. Therefore an impairment loss should be recognized.

Impairment loss recognized at 30 November 2011:
= $28,098,560 – 22,400,000
= $5,698,560

Conclusion
In this article, we have addressed to the key issues in respect of the derecognition and impairment of financial assets. Students, however, have to bear in mind that accounting requirements for financial instruments are likely to change in the future. Therefore, it is important that you fully understand the basic principles of our two-part articles on financial instruments and continue to keep yourselves updated on future developments.