

HKFRS 9 Financial Instruments

(Relevant to Paper I – PBE Financial Accounting)

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Introduction

HKFRS 9 “Financial Instruments” is the first of a three-phase project to replace HKAS 39 “Financial Instruments: Recognition and Measurement” on classification and measurement of financial instruments. Guidance on impairment methodology and hedge accounting will be published upon completion of phases 2 and 3 of the project.

HKFRS 9 is one of the essential topics for PBE Paper I “Financial Reporting”. Since HKFRS 9 covers more complex areas, our review of this subject is divided into two parts. This first part addresses the new requirements for classification and measurement of **financial assets** only. The second part will deal with de-recognition and impairment of financial assets.

Recognition of financial assets

HKFRS 9 provides that an entity should recognize a financial asset in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. This means that financial assets should be recognized when the entity becomes a party to the contract rather than when the transaction is settled. For example, an entity commits to buy HSBC’s ordinary shares on 3 October 2011 and will settle the amount on 5 October 2011. In this case, the entity should recognize HSBC’s shares as an investment in equity instruments (financial asset) on 3 October 2011 rather than 5 October 2011.

Classification of financial assets

Upon initial recognition of a financial asset, HKFRS 9 classifies financial assets on both of the following:

- (a) the entity’s business model for managing the financial assets; and
- (b) the contractual cash flow characteristics of the financial assets.

The business-model approach is fundamental to HKFRS 9, and it aims to align the measurement attribute of financial assets with the way management uses its assets in its business (its business model) while also looking at the contractual cash flow characteristics of the assets.

HKFRS 9 uses a mixed-measurement method and requires an entity to classify its financial assets into two categories:

- (a) financial assets measured at amortized cost; and
- (b) financial assets measured at fair value.

A financial asset is 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 rather than with the objective of selling the asset before its contractual maturity to realize its fair value changes; 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.

A financial asset that does not meet the criteria for amortized cost classification is measured at fair value.

Thus, an investment in a debt instrument, such as a loan or a bond, that is held within a business model whose objective is to collect the contractual cash flows and has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding, is measured at amortized cost. All other investments in debt instruments are measured at fair value. An investment in a convertible loan or a convertible bond does not qualify for measurement at amortized cost because of the inclusion of the conversion option, which often causes the contractual cash flows not to represent payments of principal and interest on the principal amount outstanding.

Measurement of financial assets

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 which should be measured at their fair value. Fair value refers to the amount of consideration paid for acquiring the asset, and transaction costs are those costs that are directly attributable to the acquisition of the asset, including fee and commission paid to agents and brokers and stamp duties.

Subsequent to initial recognition, financial assets are measured at fair value or amortized cost depending on their classification.

Financial assets measured at fair value

HKFRS 9 requires all financial assets measured at fair value to be measured at fair value with changes in fair value being recognized in profit or loss. In determining the fair value of financial assets, the best evidence is quoted prices in an active market. If the market for a financial asset is not active, an entity may establish fair value by using a valuation technique such as the current fair value of similar financial assets, discounted cash flow analysis and option price models.

The following example is modified from the PBE June 2006 examination paper. It demonstrates the classification and measurement of financial assets measured at fair value.

Example 1

Jaipack Ltd acquired the following listed shares on 23 October 2011:

100,000 ordinary shares of Bush Ltd at \$2.50 per share plus transaction costs of \$3,000
200,000 ordinary shares of Tree Ltd at \$3.50 per share plus transaction costs of \$4,000

At Jaipack Ltd's accounting year-end on 31 December 2011, the fair values of the shares were:

Ordinary shares of Bush Ltd: \$1.50 per share
 Ordinary shares of Tree Ltd: \$4.50 per share

Jaipack Ltd holds the shares in Bush Ltd and Tree Ltd primarily for the purpose of trading, i.e. the investments are acquired principally for the purpose of selling them in the near term for short-term profit-taking.

Required:

- (a) Prepare the journal entries to record the acquisition and the year-end adjustment of the shares in the books of Jaipack Ltd.
- (b) Prepare extracts from the statement of comprehensive income for the year ended 31 December 2011 of Jaipack Ltd and the statement of financial position as at that date.

Solution:

- (a) As the investments in ordinary shares of Bush Ltd and Tree Ltd are held for trading, they should be classified as financial assets measured at fair value and should be initially carried at fair value while the associated transaction costs are recognized in profit or loss. The initial carrying amount of the investments is the price paid of \$950,000 (100,000 shares x \$2.50 + 200,000 shares x \$3.5) and the expensed transaction costs are \$7,000 (\$3,000 + \$4,000). The journal entries on initial recognition are:

	Dr.	Cr.
	\$'000	\$'000
<u>23 October 2011</u>		
Investments in equity instruments – Financial assets measured at fair value	950	
Profit or loss – Transaction costs	7	
Cash		957
To record the acquisition of ordinary shares and transaction costs.		

Since the investments are subsequently measured at fair value, the changes in fair value are recognized in profit or loss in the period of the changes in fair value. The following year-end journal entries are required:

	Dr.	Cr.
	\$'000	\$'000
<u>31 December 2011</u>		
Investments in equity instruments – Financial assets measured at fair value (100,000 x \$1.5 + 200,000 x \$4.5) – \$950,000		100
Profit or loss – Gain on investments in equity instruments		100
To record the changes in fair value of the investments.		

(b)

An extract from the statement of comprehensive income of Jaipack Ltd for the year ended 31 December 2011

	\$'000
Income	
Gain on investments in equity instruments	100
Expense	
Transaction costs	7

An extract from the statement of financial position of Jaipack Ltd as at 31 December 2011

	\$'000
Current assets	
Investments in equity instruments – Financial assets measured at fair value*	1,050

*HKAS 1 “Presentation of Financial Statements” provides that current assets include assets held primarily for the purpose of trading (e.g. those financial assets classified as held for trading in accordance with HKAS 39).

Students should note that HKFRS 9 contains a new requirement in relation to investments in equity instruments. If an investment in equity instruments is not held for trading, an entity can make an irrevocable election at initial recognition to measure it at fair value through other comprehensive income with only dividends recognized in profit or loss.

Financial assets measured at amortized cost

As required by HKFRS 9, financial assets measured at amortized cost should be subsequently measured at amortized cost using the effective interest method.

For a financial asset, the effective interest method is a method of calculating the amortized cost of the asset and of allocating the interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the asset. The amortized cost of a financial asset is the amount at which the asset is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount.

The following example is modified from the PBE December 2004 examination paper. It demonstrates the technique required to determine the amortized cost of financial assets calculated using the effective interest method.

Example 2

On 1 January 2008, Alpha Ltd purchased bonds with four years remaining to maturity at their fair value of \$241,135 (including transaction costs). The bonds have a principal amount of \$250,000 and carry fixed interest of 4% that is receivable annually, in arrears, on 31 December over the next four years.

Alpha Ltd holds the bonds within a business model whose objective is to hold financial assets in order to collect contractual cash flows.

Required:

- (a) Determine the effective interest rate for the bonds.
- (b) Prepare Alpha Ltd's amortization table for the investment in bonds for the years ended 31 December 2008 to 2011.
- (c) Prepare the relevant journal entries relating to the investment in bonds in the books of Alpha Ltd for the years ended 31 December 2008 to 2011.

Solution:

- (a) The effective interest rate is the rate that exactly discounts the expected cash flows on the bonds to the initial carrying amount.

Let the annual effective interest rate be r ,
$$\$241,135 = \$10,000/(1+r)^1 + \$10,000/(1+r)^2 + \$10,000/(1+r)^3 + \$260,000/(1+r)^4$$
$$\Rightarrow r = 5\%$$

- (b) The discount on bonds is \$8,865 (\$241,135 – \$250,000). The amortization table below provides information about the amortized cost, cash flows, interest income and amortization of the discount for the bonds in each year.

Year	Amortized cost at start of year	Cash receipts (\$250,000 x 4%)	Interest income recognized	Discount amortization	Amortized cost at end of year
	(A)	(B)	(C) = (A) x 5%	(D) = (B) – (C)	(E) = (A) – (D)
	\$	\$	\$	\$	\$
2008	241,135	10,000	12,057	(2,057)	243,192
2009	243,192	10,000	12,160	(2,160)	245,352
2010	245,352	10,000	12,268	(2,268)	247,620
2011	247,620	<u>10,000</u>	12,380*	<u>(2,380)</u>	250,000
		<u>40,000</u>		<u>(8,865)</u>	

*rounded up figure

- (c) The relevant journal entries relating to bonds in the books of Alpha Ltd from 2008 to 2011 are:

	Dr.	Cr.
	\$	\$
<u>1 January 2008</u>		
Bonds – Financial assets measured at amortized cost	241,135	
Cash		241,135
To record the purchase of bonds.		
<u>31 December 2008</u>		
Cash	10,000	
Bonds – Financial assets measured at amortized cost	2,057	
Profit or loss – Interest income		12,057
To record the receipt of cash, interest income and discount amortization of bonds.		

31 December 2009

Cash	10,000	
Bonds – Financial assets measured at amortized cost	2,160	
Profit or loss – Interest income		12,160

To record the receipt of cash, interest income and discount amortization of bonds.

31 December 2010

Cash	10,000	
Bonds – Financial assets measured at amortized cost	2,268	
Profit or loss – Interest income		12,268

To record the receipt of cash, interest income and discount amortization of bonds.

31 December 2011

Cash	10,000	
Bonds – Financial assets measured at amortized cost	2,380	
Profit or loss – Interest income		12,380

To record the receipt of cash, interest income and discount amortization of bonds.

31 December 2011

Cash	250,000	
Bonds – Financial assets measured at amortized cost		250,000

To record the receipt of principal on maturity.

Conclusion

Students sitting PBE Paper I “Financial Accounting” must possess general knowledge of accounting for financial instruments and use the knowledge in straightforward business situations. In this article, we have explained the principles of recognition, classification and measurement of financial assets in applying of HKFRS 9. In our next article (in October 2012 issue) we will look at some of the more complex areas of financial assets – de-recognition and impairment.