International Valuation Limited
國際評估有限公司

Technical Update – New HKFRS 9 valuation requirements

Starting from financial year 1 Jan 2018 to 31 Dec 2018, the new HKFRS 9 - Financial Instruments becomes effective. From then on, additional fair value measurements for debts and receivables as well as unquoted equities financial assets will be required:

Expected Credit Losses (ECL)

With ECL measurements for loans, receivables, and debt securities become mandatory, Simplified or General Approaches with different ECL measurement periods will be applied to different instruments.

	Simplified Approach	**General Approach**
Applicable assets	Trade receivables, contract assets (HKFRS 15) and lease receivables (HKAS 17 / HKFRS 16)	Other financial assets
ECL measurement period	12 months	Stage 1: 12 months Stage 2-3: Lifetime

Under the Simplified Approach, a 12-month ECL can be calculated by the formula:
Expected Credit Losses (ECL) = Exposure at Default (EAD) * Probability of Default (PD) * Loss Given Default (LGD) * Discount Factor (DF)
(Note: DF may be skipped if payment period within 1 year is assumed.)

A provision matrix can be applied to calculate the ECL based on payment and default history or other benchmarks, grouped by payment periods.

Overdue Period	**Gross Receivable Amount (EAD)**	**Probability of Default (PD)**	**Expected Credit Losses ECL=EAD*PD*LGD**
Current			
Within 1 month			
…			
More than 1 year			

(Note: DF may be skipped if payment period within 1 year is assumed.)

Under the General Approach, measurements of 12-month or lifetime ECL may be required, depending on the stage of the credit instruments according to their credit status:

Stages	Stage 1	Stage 2	Stage 3
Assets condition	Performing (initial recognition)	Underperforming (with significant increase in credit risk)	Non-performing (credit-impaired)
Period	12-month	Lifetime	Lifetime

When a trade/loan receivable or debt-type financial asset was recognized at initial inception (non-credit-impaired), a 12-month ECL can be measured similar to the Simplified Approach (Stage 1). In subsequent measurements at the end of financial reporting periods, any indicator of significant increase in credit risk will be assessed. If significant increase in credit risk is identified, measurement of lifetime ECL will be needed. Cumulative default probability over time or survival analysis can be adopted to estimate the lifetime ECL (Stage 2). If the credit standing of an asset has been impaired at the time of acquisition (as in case on distressed asset purchase), lifetime ECL measurement is also required at initial recognition (Stage 3).

Unquoted equity investments – removal of Available-For-Sale (AFS) valuation exemption

Previously, under HKAS 39, investments in unquoted equities classified as AFS can be exempted from fair value measurements and are allowed to be booked at cost, subject to impairment review. This exemption is removed in HKFRS 9, whereby financial assets classified as Fair Value Through Profit & Loss (FVTPL) and Fair Value Through Other Comprehensive Income (FVTOCI) should be recorded at fair value.

When valuing the minority equity stakes in other companies (usually in the form of ordinary, preferred shares, or convertible bonds), special complications may arise in a number of ways:

- financial forecast or even latest financial or operating data may not be available from management;
- sophisticated tailor-made models required for companies with complex capital structure;
- investments requiring fair value measurements can be numerous; and
- some investees may be at very early stage, before break-even or pre-revenue, and lacks appropriate benchmarking metrics for valuation purpose.

Valuations of such investments entail in-depth understanding of investment instruments and investees in order to apply appropriate valuation methods accordingly. When financial forecasts are not available, valuation by market or cost approach may become more practical. Valuation models which calibrate model results with transaction prices are more than helpful and in line with the spirit of HKFRS 13. Option or binomial models may be applied to allocate company values into different share classes depending on their respective share terms.

Jack Leung (Director), CFA, CVA, FRM, MPhil
T: (852) 2349 1698 / E: jack@ivl.hk