

IAS 32, IAS 39, IFRS 4 and IFRS 7

(Afternoon Session)

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Today's Agenda

Morning Session

- Financial Instruments: Recognition and Measurement (IAS 39)
- Derivative (IAS 39)

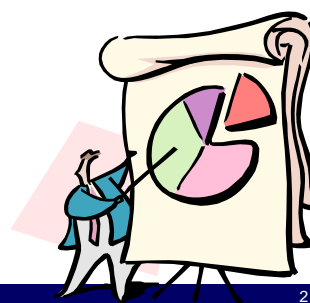
Afternoon Session

- Insurance Contracts (IFRS 4)
- Derecognition (IAS 39)
- Hedging (IAS 39)
- Financial Instruments: Presentation (IAS 32)
- Financial Instruments: Disclosure (IFRS 7)

Simple but
Comprehensive

Contentious and
key issues

Real Life Cases
and Examples



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Today's Agenda – Afternoon

Insurance
Contracts

Derecognition

Hedging

FI: Presentation

FI: Disclosure

Afternoon Session

- Derecognition (IAS 39)
- Hedging (IAS 39)
- Financial Instruments: Presentation
- Financial Instruments: Disclosure (IFRS 7)
- Insurance Contracts (IFRS 4)

Today's Agenda – Afternoon

Insurance
Contracts

Afternoon Session



Insurance Contracts (IFRS 4)

1. Objective and Summary
2. Definition of an insurance contract
3. Scope of IFRS 4
 - Embedded Derivatives
 - Unbundling of deposit components
4. Recognition and Measurement
 - Temporary exemption from some other IFRSs
 - Changes in accounting policies
 - Insurance contracts acquired in a business combination or portfolio transfer
 - Discretionary participation features
5. Disclosure



1. Objective and Summary

- The objective of IFRS 4 is
 - to specify the financial reporting for insurance contracts by any entity that issues such contracts (described in IFRS 4 as an insurer).
- In particular, IFRS 4 requires:
 - a) limited improvements to accounting by insurers for insurance contracts.
 - b) disclosure that
 - identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and
 - helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

Issuers

Limited Improvements

Disclosure

1. Objective and Summary

Case 1

Ping An Insurance (Group) Co. of China, Ltd.



- Accounting report 2005 (1st year in adopting IFRS 4)
 - Effective January 1, 2005, the Group adopted IFRS 4.
 - IFRS 4 represents the completion of phase 1 of the first IFRS to deal with insurance contracts.
 - The main features of IFRS 4 include but are not limited to
 - the definition of an insurance contract,
 - the use of liability adequacy tests and impairment tests for reinsurance assets, and
 - prohibition of catastrophe and equalization provisions.
 - Based on this standard, the Group continues to account for investment contracts containing discretionary participation features as if they are insurance contracts.
 - In addition, premium income from certain contracts, which are regarded as investment contracts by IFRS 4, is accounted for as financial liabilities, and related policyholders' benefits to the extent covered by the said contracts are accounted for as a direct debit to the financial liabilities.

1. Objective and Summary

Case 1

Ping An Insurance (Group) Co. of China, Ltd.



- Accounting report 2005 (1st year in adopting IFRS 4)
 - Further, certain investment-linked contracts meet the definition of an insurance contract under IFRS 4 and the Group separately presents assets and liabilities related to such investment-linked contracts, which were originally grouped in "separate account (investment-linked) assets and liabilities".
 - The assets and liabilities related to the remaining investment-linked contracts, which are regarded as investment contracts, are presented as policyholder account assets and liabilities in respect of investment contracts.
 - As a result of the adoption of IFRS 4, certain contracts were reclassified as investment contracts.

2. Definition of Insurance Contract

Significant
Insurance Risk

Uncertain
future event

- IFRS 4 define **Insurance Contract** as
 - A contract under which one party (the insurer)
 - accepts **significant insurance risk** from another party (the policyholder)
 - by agreeing to compensate the policyholder
 - if a specified **uncertain future event** (the insured event) adversely affects the policyholder.

- Insurance risk should be assessed at the inception of the contract.
- A contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished or expire.

2. Definition of Insurance Contract

Significant
Insurance Risk



- **Insurance risk** is defined in IFRS 4 as
 - risk, other than financial risk, transferred from the holder of a contract to the issuer.
- The definition of insurance risk
 - refers to risk that the insurer accepts from the policyholder.
- In other words, insurance risk
 - is a pre-existing risk transferred from the policyholder to the insurer; and
 - a new risk created by the contract is not insurance risk.

2. Definition of Insurance Contract

Significant Insurance Risk

- IFRS 4.B8 specifically requires that:
 - A contract that exposes the issuer to financial risk without significant insurance risk
 - is not an insurance contract.
- **Financial risk** is defined in IFRS 4 as
 - The risk of a possible future change
 - in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, (i.e. financial variable)
 - provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

It excludes non-financial variables that are specific to a party to the contract

2. Definition of Insurance Contract

Case 2



- Accounting report 2006

Classification of contracts

- Contracts under which the group accepts significant insurance risk from another party (“the policyholder”) by agreeing to compensate the policyholder if a specified uncertain future event (“the insured event”) adversely affects the policyholder are classified as insurance contracts.
 - Insurance risk is the risk other than financial risk.
 - Financial risk is the risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party of the contract.
 - Insurance contracts may also transfer some financial risk.

2. Definition of Insurance Contract

Example 1

Are the following contracts an insurance contract?

1. Life insurance contracts in which the insurer bears no significant mortality risk ✗ No significant insurance risk
2. Self-insurance ✗ No risk transfer
No another party
3. Product warranties issued by another party for goods sold by a manufacturer ✓
4. Product warranties issued by a manufacturer directly ✗ Specifically not within the scope
5. Reinsurance contracts ✓
6. Contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract ✗ Not specific to a party

2. Definition of Insurance Contract

Example 1

Are the following contracts an insurance contract?

7. Catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond ✓
8. Catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract ✗ Not specific to a party
9. Travel assistance (i.e. compensation in cash or in kind to holders for losses suffered while they are travelling) ✓
10. Insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract. ✓

2. Definition of Insurance Contract

Significant
Insurance Risk

For example, by
reference to the
stage of completion
of the transaction

- A contract in the legal form of an insurance contract is not an insurance contract under IFRS 4 if it cannot meet the definition in IFRS 4.
- If such contract creates financial assets or financial liabilities, they are within the scope of IAS 39.
 - Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:
 - a) one party recognises the consideration received as a financial liability, rather than as revenue.
 - b) the other party recognises the consideration paid as a financial asset, rather than as an expense.
- If such contract does not create financial assets or financial liabilities, IAS 18 Revenue applies.

2. Definition of Insurance Contract

Case 3



- Accounting report 2005
(1st year in adopting HKAS 39 and HKFRS 4)

– The adoption of HKFRS 4 has resulted in the reclassification of certain insurance contracts as investment contracts and hence the application of HKAS 39 to those contracts

Investment contracts

- Contracts under which the transfer of insurance risk to the Group from the policyholder is not significant are classified as investment contracts.
- Investment contracts without DPF, previously classified as insurance contracts, are now classified as investment contracts and are accounted for under HKAS 39.
 - As a result, the life insurance funds related to these investment contracts were reclassified as investment contract liabilities on 1 January 2005.
 - Investment contract liabilities now comprise the policyholders' benefits payable, the premiums received from these contracts and the related investment income generated.
 - Contributions from investment contracts are credited directly to investment contract liabilities and only policy administration fees are now recognised as income in the income statement.

2. Definition of Insurance Contract

Additional benefits
• refer to amounts that exceed those that would be payable if no insured event occurred

Substance is required



- A contract is an insurance contract only if it transfers **significant** insurance risk.
- Insurance risk is significant if, and only if,
 - an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (i.e. have no discernible effect on the economics of the transaction).
- If significant additional benefits would be payable in scenarios that have commercial substance, the condition in the previous sentence may be met
 - even if the insured event is extremely unlikely or
 - even if the expected (i.e. probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows.

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2. Definition of Insurance Contract

Significant
Insurance Risk



- An insurer shall assess the significance of insurance risk
 - contract by contract,
 - rather than by reference to materiality to the financial statements.
- Thus, insurance risk may be significant even if there is a minimal probability of material losses for a whole book of contracts.
 - This contract-by-contract assessment makes it easier to classify a contract as an insurance contract.
- However, if a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk,
 - an insurer need not examine each contract within that book to complete the assessment.

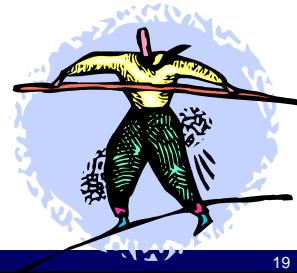
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2. Definition of Insurance Contract

Uncertain
future event

- Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:
 - a) whether an insured event will occur;
 - b) when it will occur; or
 - c) how much the insurer will need to pay if it occurs.



2. Definition of Insurance Contract

Uncertain
future event

- In some insurance contracts,
 - the insured event is the discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract.
- In other insurance contracts,
 - the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.
- Some insurance contracts
 - cover events that have already occurred, but whose financial effect is still uncertain,
 - for example, a reinsurance contract that covers the direct insurer against adverse development of claims already reported by policyholders.
 - In such contracts, the insured event is the discovery of the ultimate cost of those claims.

3. Scope of IFRS 4

- An entity shall apply IFRS 4 to:
 - a) **insurance contracts** (including reinsurance contracts) that it issues and **reinsurance contracts** that it holds.
 - b) **financial instruments that it issues with a discretionary participation feature.**
 - IAS 32 *Financial Instruments: Disclosure* requires disclosure about financial instruments, including financial instruments that contain such features.
- IFRS 4 does not address other aspects of accounting by insurers,
 - such as accounting for financial assets held by insurers and financial liabilities issued by insurers

Insurance and Reinsurance Contract

Financial Instrument with DP Feature



3. Scope of IFRS 4

- An entity shall not apply IFRS 4 to:
 - a) product warranties issued directly by a manufacturer, dealer or retailer
 - b) employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans.
 - c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, and similar items), as well as a lessee's residual value guarantee embedded in a finance lease.
 - d) financial guarantee contracts (unless IFRS 4 is allowed and is elected for application by the entity).
 - e) contingent consideration payable or receivable in a business combination.
 - f) direct insurance contracts that the entity holds (the entity is the policyholder). However, a cedant shall apply IFRS 4 to reinsurance contracts that it holds.

IAS 18 & 37

IAS 19 & IFRS 2

IAS 26

IAS 17, 18 & 38

IAS 39

IFRS 3

3. Scope of IFRS 4

- For ease of reference, IFRS 4 describes any entity that issues an insurance contract as an insurer,
 - whether or not the issuer is regarded as an insurer for legal or supervisory purposes.
- A reinsurance contract is a type of insurance contract.
 - Accordingly, all references in IFRS 4 to insurance contracts also apply to reinsurance contracts.

Even it is not an insurance company under the law



3. Scope – Embedded Derivatives

- IAS 39 requires an entity to separately measure some embedded derivatives from their host contract.
- As an exception to the requirement in IAS 39,
 - an insurer is not required to separately measure a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate),
 - even if the exercise price differs from the carrying amount of the host insurance liability.



3. Scope – Embedded Derivatives

- However, such requirement in IAS 39
 - does apply to a put option or cash surrender option embedded in an insurance contract
 - if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a non-financial variable that is not specific to a party to the contract.
 - also applies if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level).
- The above requirement applies equally to options to surrender a financial instrument containing a discretionary participation feature.

Why?



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3. Scope – Unbundling of Deposit

- Some insurance contracts contain both an insurance component and a deposit component. In some cases, an insurer is required or permitted to unbundle those components:
 - a) unbundling is required if both the following conditions are met:
 - i) the insurer can measure the deposit component (including any embedded surrender options) separately (i.e. without considering the insurance component).
 - ii) the insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component.
 - b) unbundling is permitted, but not required, if the insurer can measure the deposit component separately as in (a)(i) but its accounting policies require it to recognise all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations.
 - c) unbundling is prohibited if an insurer cannot measure the deposit component separately as in (a)(i).

Unbundling required

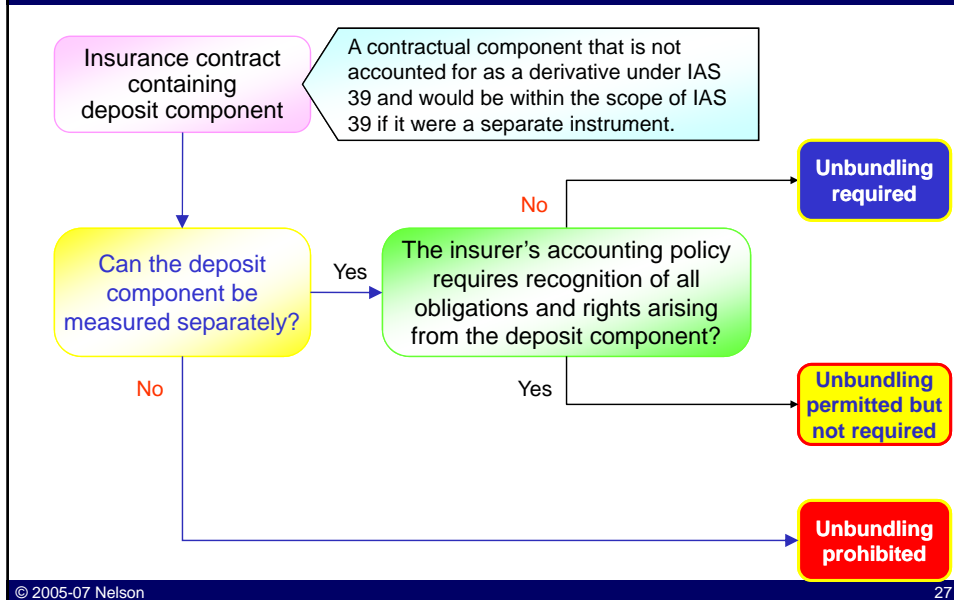
Unbundling permitted but not required

Unbundling prohibited

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3. Scope – Unbundling of Deposit



3. Scope – Unbundling of Deposit

Example 2

Insurance contract containing deposit component

- ATT Insurance Inc. receives compensation for losses from a reinsurer, but the contract obliges it to repay the compensation in future years.
- That obligation arises from a deposit component, which can be separately measured by ATT.
- ATT's accounting policies permit it to recognise the compensation as income without recognising the resulting obligation.
- Is the unbundling of the deposit component required for ATT?

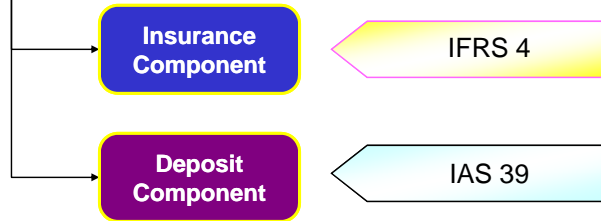
Yes, unbundling of the deposit component is required since

1. ATT can measure the deposit component separately, and
2. Its accounting policies only require ATT to recognise the compensation as income and do not require it to recognise all obligation arising from the deposit component.

3. Scope – Unbundling of Deposit

Insurance contract containing deposit component

- To unbundle a contract, an insurer shall:
 - Apply IFRS 4 to the insurance component.
 - Apply IAS 39 to the deposit component



3. Scope – Unbundling of Deposit

Case 4



- Accounting report 2005 (1st year in adopting HKAS 39 and HKFRS 4)

- Some insurance contracts comprise an insurance component and a deposit component.
- Under HKFRS 4, an insurer is required to unbundle the deposit component if
 - o the insurer can measure the deposit component (including any embedded surrender options) separately and
 - o its accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component.
- The Group chose not to unbundle the deposit component of all of its insurance contracts as
 - o its accounting policies require it to recognise all obligations and rights arising from the deposit component, though the Group can measure the deposit component separately.
 - o The accounting treatment is specifically permitted under HKFRS 4.
- Guaranteed annuity options and other options and guarantees inherent in some insurance contracts issued by the Group that transfer significant insurance risk to the Group are not separated and measured at fair value.

4. Recognition and Measurement

Temporary exemption from some other IFRSs

- If no IFRS applies specifically to an item, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specifies criteria for an entity to use in developing an accounting policy,
 - In particular, IAS 8.10 to 8.12
- However, IFRS exempts an insurer from applying those criteria to its accounting policies for:
 - a) insurance contracts that it issues
 - including related acquisition costs and related intangible assets, such as those described in IFRS 4.31 and IFRS 4.32; and
 - b) reinsurance contracts that it holds.



Exempted from IAS
8.10 to 8.12

4. Recognition and Measurement

IAS 8.10 requires that, in the absence of a IFRS or Interpretation that specifically applies to a transaction, other event or condition

Management shall use its **judgement** in developing and applying an accounting policy that results in information that is:

- a) **Relevant** to the economic decision-making needs of users; and
- b) **Reliable**

Reliable → information in that the financial statements:

- i) **represent faithfully** the financial position, financial performance and cash flows of the entity;
- ii) reflect the **economic substance** of transactions, other events and conditions, and not merely the legal form;
- iii) are **neutral**, i.e. free from bias;
- iv) are **prudent**; and
- v) are **complete** in all material respects.

Exempted from IAS
8.10 to 8.12

4. Recognition and Measurement

IAS 8.11 and 8.12 specify sources of authoritative requirements and guidance and states that

- In making judgement in developing and applying an accounting policy that results in relevant and reliable information
 - 1) management shall consider the applicability of, the following sources in descending order:
 - a) the requirements and guidance in IFRS and Interpretations dealing with similar and related issues; and
 - b) the definitions, recognition criteria and measurement concepts for elements in the Framework.
 - 2) management may also consider the most recent pronouncements of other standard-setting bodies (subject to limitations and not conflict with the sources in point 1 above).

Exempted from IAS
8.10 to 8.12

4. Recognition and Measurement

- IFRS 4 does not exempt an insurer from some implications of the criteria in IAS 8.10 to IAS 8.12. Specifically, an insurer:
 - a) shall not recognise as a liability any provisions for possible future claims,
 - if those claims arise under insurance contracts that are not in existence at the reporting date (such as catastrophe provisions and equalisation provisions).
 - b) shall carry out the liability adequacy test described IFRS 4.
 - c) shall remove an insurance liability (or part of an insurance liability) from its balance sheet
 - when, and only when, it is extinguished (discharged, cancelled or expires).
 - d) shall not offset:
 - i) reinsurance assets against the related insurance liabilities; or
 - ii) income or expense from reinsurance contracts against the expense or income from the related insurance contracts.
 - e) shall consider whether its reinsurance assets are impaired.

Exempted from IAS
8.10 to 8.12

4. Recognition and Measurement

Case 5



- Accounting report 2005
(1st year in adopting HKAS 39 and HKFRS 4)

- In prior years, insurance contract provisions are net of reinsurance assets in the balance sheet.
- In accordance with HKFRS 4, reinsurers' share of insurance contract provisions are separately disclosed in the balance sheet and do not offset against the related insurance contract provisions.
- The change in policy had no effect on the profit or loss of the Group.
- Comparative amounts have been restated in accordance with the transitional provisions of HKFRS 4.
- As a result of the adoption of HKFRS 4, certain details regarding the Group's insurance contracts are disclosed in note 3 to the financial statements.

4. Recognition and Measurement

- Liability adequacy test
 - An insurer shall assess at each reporting date whether its recognised insurance liabilities are adequate,
 - using current estimates of future cash flows under its insurance contracts.
 - If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those discussed in IFRS 4.31 and 4.32) is inadequate in the light of the estimated future cash flows,
 - the entire deficiency shall be recognised in profit or loss. (IFRS 4.15)



4. Recognition and Measurement

Minimum Requirements

- If an insurer applies a liability adequacy test that meets specified minimum requirements, IFRS 4 imposes no further requirements.
- The minimum requirements are the following:
 - a) The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.
 - b) If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss.



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4. Recognition and Measurement

Minimum Requirements

If not meet



- If the minimum requirements are not met, the insurer shall:
 - a) determine the carrying amount of the relevant insurance liabilities less the carrying amount of:
 - i) any related deferred acquisition costs (DAC); and
 - ii) any related intangible asset (related reinsurance assets are not considered)
 - b) determine whether the amount described in (a) is less than the carrying amount that would be required if the relevant insurance liabilities were within the scope of IAS 37. If it is less, the insurer shall
 - recognise the entire difference in profit or loss and
 - decrease the carrying amount of the related deferred acquisition costs or related intangible assets or increase the carrying amount of the relevant insurance liabilities.

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4. Recognition and Measurement

Case 6

China Life Insurance Company Limited



- Accounting report 2006

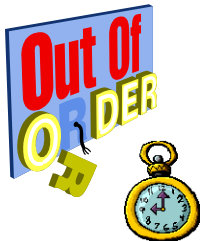
- Liability Adequacy Test

- At each balance sheet date, liability adequacy tests are performed to ensure the adequacy of the contract liabilities net of related DAC (deferred acquisition cost).
 - In performing these tests, current best estimates of future cash flows for each category of contracts are used to determine any deficiency for those contracts.
 - Any deficiency is immediately charged to income statement initially by writing off DAC and by subsequently establishing a provision for losses arising from liability adequacy tests (the unexpired risk provision).
 - Any DAC written off as a result of the liability adequacy test cannot be subsequently reinstated.

4. Recognition and Measurement

- If a cedant's reinsurance asset is impaired,
 - the cedant shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss.

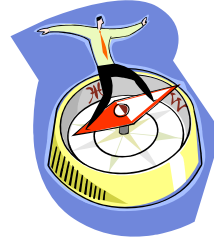
- A reinsurance asset is impaired if, and only if:
 - a) there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and
 - b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.



4. Recognition and Measurement

Changes in accounting policies

- An insurer may change its accounting policies for insurance contracts
 - if, and only if, the change makes the financial statements
 - more relevant to the economic decision-making needs of users and no less reliable, or
 - more reliable and no less relevant to those needs.
- An insurer shall judge relevance and reliability by the criteria in IAS 8.
- Any changes should bring financial statements closer to IAS 8



4. Recognition and Measurement

Changes in accounting policies

- Specific issues are discussed below:
 - a) current interest rates (IFRS 4.24);
 - b) continuation of existing practices (IFRS 4.25);
 - c) prudence (IFRS 4.26);
 - d) future investment margins (IFRS 4.27–29); and
 - e) shadow accounting (IFRS 4.30)



4. Recognition and Measurement

Changes in accounting policies

- Specific issues are discussed below:

- a) current interest rates (IFRS 4.24);

Permit (but not require) an insurer to re-measure designated insurance liabilities to reflect

- current market interest rates (and changes recognised in P/L), or
- other current estimates and assumptions

4. Recognition and Measurement

Changes in accounting policies

- Specific issues are discussed below:

- b) continuation of existing practices (IFRS 4.25);

An insurer cannot introduce any accounting policies not in accordance with IAS 8, but can continue the following practices:

1. Measure insurance liabilities on an undiscounted basis
2. Measure contractual rights to future investment management fees not at fair value
3. Use non-uniform accounting policies for the insurance contracts of subsidiaries

4. Recognition and Measurement

Changes in accounting policies

- Specific issues are discussed below:

c) prudence (IFRS 4.26);

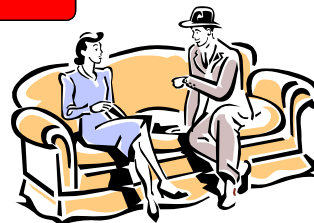


- No need to change accounting policies for insurance contract to eliminate excessive prudence
- Cannot introduce additional prudence

4. Recognition and Measurement

Changes in accounting policies

- Specific issues are discussed below:



d) future investment margins (IFRS 4.27–29)

- No need to change accounting policies to eliminate future investment margins
- But cannot introduce such policies as well

4. Recognition and Measurement

Changes in accounting policies

- Specific issues are discussed below:

e) shadow accounting
(IFRS 4.30)

- In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of (a) its insurance liabilities, (b) related deferred acquisition costs and (c) related intangible assets, such as those described in paragraphs 31 and 32.
- An insurer is permitted, but not required, to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does.

4. Recognition and Measurement

Business Combination or Portfolio Transfer

- Instead of separately stating the insurance liabilities assumed and insurance assets acquired (in a business combination or portfolio transfer) at fair value, an insurer is permitted, but not required, to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:
 - a) a liability (measured same as other insurance contracts)
 - b) an intangible asset, representing the difference between
 - The fair value of the acquired insurance contract and the amount of above liability as described in (a).
- The subsequent measurement of this asset shall be consistent with the measurement of the related insurance liability.

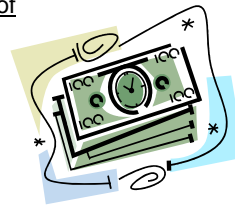
Impairment
excluded from
IAS 36 & 38

4. Recognition and Measurement

Discretionary Participation Features

Discretionary participation feature is defined in IFRS 4 as:

- A contractual right to receive, as a supplement to guaranteed benefits, additional benefits:
 - a) that are likely to be a significant portion of the total contractual benefits;
 - b) whose amount or timing is contractually at the discretion of the issuer; and
 - c) that are contractually based on:
 - i) the performance of a specified pool of contracts or a specified type of contract;
 - ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
 - iii) the profit or loss of the company, fund or other entity that issues the contract.



4. Recognition and Measurement

Discretionary Participation Features

- Some insurance contracts contain a discretionary participation feature as well as a **guaranteed element**.
- The issuer of such a contract:
 - a) may, but need not, recognise the **guaranteed element** separately from the discretionary participation feature.
 - If the issuer does not recognise them separately, it shall classify the whole contract as a liability.
 - If the issuer classifies them separately, it shall classify the guaranteed element as a liability.

**Guarantee
Element**

Separately
Recognised?

4. Recognition and Measurement

Discretionary Participation Features

- Some insurance contracts contain a discretionary participation feature as well as a guaranteed element.
- The issuer of such a contract:
 - b) shall, if it recognises the discretionary participation feature separately from the guaranteed element, classify that feature as either a liability or a separate component of equity.
 - IFRS 4 does not specify how the issuer determines whether that feature is a liability or equity.
 - The issuer
 - may split that feature into liability and equity components and
 - shall use a consistent accounting policy for that split.
 - The issuer shall not classify that feature as an intermediate category that is neither liability nor equity.

Discretionary
Participation
Feature

4. Recognition and Measurement

Discretionary Participation Features

- Some insurance contracts contain a discretionary participation feature as well as a guaranteed element.
- The issuer of such a contract:
 - c) may recognise all premiums received as revenue without separating any portion that relates to the equity component.
 - The resulting changes in the guaranteed element and in the portion of the discretionary participation feature classified as a liability shall be recognised in profit or loss.
 - If part or all of the discretionary participation feature is classified in equity, a portion of profit or loss may be attributable to that feature (in the same way that a portion may be attributable to minority interests).
 - The issuer shall recognise the portion of profit or loss attributable to any equity component of a discretionary participation feature as an allocation of profit or loss, not as expense or income (see IAS 1 Presentation of Financial Statements).

Premiums

4. Recognition and Measurement

Discretionary Participation Features

- Some insurance contracts contain a discretionary participation feature as well as a guaranteed element.
- The issuer of such a contract:
 - d) shall, if the contract contains **an embedded derivative** within the scope of IAS 39,
 - apply IAS 39 to that embedded derivative.
 - e) shall, in all respects not described in IFRS 4 (IFRS 4.14 to 4.20 and 4.34a to 4.34d), continue its existing accounting policies for such contracts,
 - unless it changes those accounting policies in a way that complies with IFRS 4 (IFRS 4.21 to 4.30).

Embedded
Derivative

4. Recognition and Measurement

Discretionary Participation Features

- The requirements on discretionary participation features in IFRS 4 also apply to a financial instrument that contains a discretionary participation feature.
- In addition:
 - a) if the issuer classifies the entire discretionary participation feature as a liability, it shall apply the liability adequacy test to the whole contract (including the discretionary participation feature).
 - b) if the issuer classifies part or all of that feature as a separate component of equity, the liability recognised for the whole contract shall not be less than the amount that would result from applying IAS 39 to the guaranteed element.
 - c) although these contracts are financial instruments, the issuer may
 - continue to recognise the premiums for those contracts as revenue and
 - recognise as expense the resulting increase in carrying amount of the liability.
 - d) although these contracts are financial instruments, an issuer applying IFRS 7.20b to contracts with a discretionary participation feature shall disclose the total interest expense recognised in profit or loss, but need not calculate such interest expense using the effective interest method.

4. Recognition and Measurement

Case 7

China Life Insurance Company Limited



- Accounting report 2005 (1st year in adopting HKAS 39 & HKFRS 4)
 - Long-term investment type insurance contracts include
 - life insurance and annuity contracts with significant investment features but with sufficiently significant insurance risk to still be considered insurance contracts under HKFRS 4.
 - During 2005, HKFRS 4 was adopted. HKFRS 4 permits the existing accounting policies to be applied to all contracts deemed to be insurance contracts under HKFRS 4.
 - As a result, these long-term investment type insurance contracts and investment contracts with DPF continue to be accounted for as follows:
 - revenue from these contracts consists of various charges (policy fees, handling fees, management fees, surrender charges) made against the contract for the cost of insurance, expenses and early surrender.

4. Recognition and Measurement

Case 7

China Life Insurance Company Limited



- Accounting report 2005 (1st year in adopting HKAS 39 & HKFRS 4)
 - As a result, these long-term investment type insurance contracts and investment contracts with DPF continue to be accounted for as follows:
 - revenue from these contracts consists of various charges (policy fees, handling fees, management fees, surrender charges) made against the contract for the cost of insurance, expenses and early surrender.
 - Excess first year charges are deferred as an unearned revenue liability and are recognised in income over the life of the contracts in a constant relationship to estimated gross profits
 - To the extent unrealised gains or losses from available-for-sale securities affect the estimated gross profits, shadow adjustments are recognised in equity.
 - Policy benefits and claims that are charged to expenses include benefit claims incurred in the year in excess of related contract balances and interest credited to these contracts.
 - The policyholder liability for long-term investment type insurance contracts and investment contracts with DPF represents the accumulation of premium received less charges, as described above.

4. Recognition and Measurement

Case 7

China Life Insurance Company Limited



- Accounting report 2006

- DPF in long-term insurance contracts and investment contracts
 - DPF (Discretionary Participation Feature) is contained in certain long-term insurance contracts and investment contracts.
 - These contracts are collectively called participating contracts.
 - The Group is obligated to pay to the policyholders of participating contracts at least 70% of distributable surplus, which includes mainly net investment income and realised gains and losses arising from the assets supporting these contracts; if this eligible surplus has not been declared and paid, it is included in the policyholder dividends payable.
 - The policyholders' share of unrealised gains or losses in respect of assets held by the Group, which may be paid to participating policyholders in the future under the policy terms in respect of assets, is also included in the policyholder dividends payable.

5. Disclosure

- An insurer shall disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts.
- To comply with this above, an insurer shall disclose:
 - a) its accounting policies.
 - b) the recognised assets, liabilities, income and expense (and, if available, cash flows) arising from insurance contracts. Furthermore, if the insurer is a cedant, it shall disclose:
 - i) gains and losses recognised in P/L on buying reinsurance; and
 - ii) if the cedant defers and amortises gains and losses arising on buying reinsurance, the amortisation for the period and the amounts remaining unamortised at the beginning and end of the period.
 - c) the process used to determine the assumptions (and if practicable quantified disclosure of those assumptions).
 - d) the effect of changes in assumptions (showed separately if material effect).
 - e) reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs.

5. Disclosure

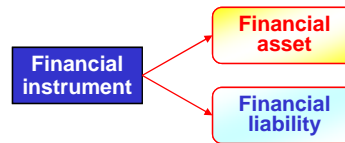
- An insurer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts. Thus, an insurer shall disclose:
 - a) its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks.
 - b) information about insurance risk (both before and after risk mitigation by reinsurance), including information about:
 - i) sensitivity to insurance risk.
 - ii) concentrations of insurance risk, including how management determines concentrations and the shared characteristic that identifies each concentration (eg type of insured event, geographical area, or currency).
 - iii) actual claims compared with previous estimates, i.e. claims development (no disclosure for uncertainty resolved within a year)
 - go back to the period when the earliest material claim arose for which uncertainty exists
 - need not go back more than ten years

5. Disclosure

- An insurer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts. Thus, an insurer shall disclose:
 - c) information about credit risk, liquidity risk and market risk but:
 - i) need not provide the maturity analysis required by IFRS 7
 - if it discloses information about the estimated timing of the net cash outflows resulting from recognised insurance liabilities instead.
 - ii) if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis,
 - it may use that sensitivity analysis to meet the requirement in IFRS Z.
 - d) information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.

Today's Agenda – Afternoon

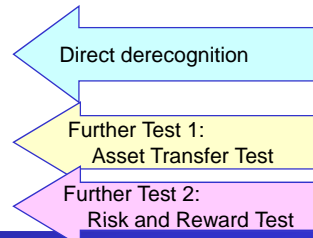
Derecognition



Derecognition of Financial Assets

An entity shall derecognise a **financial asset** when, and only when:

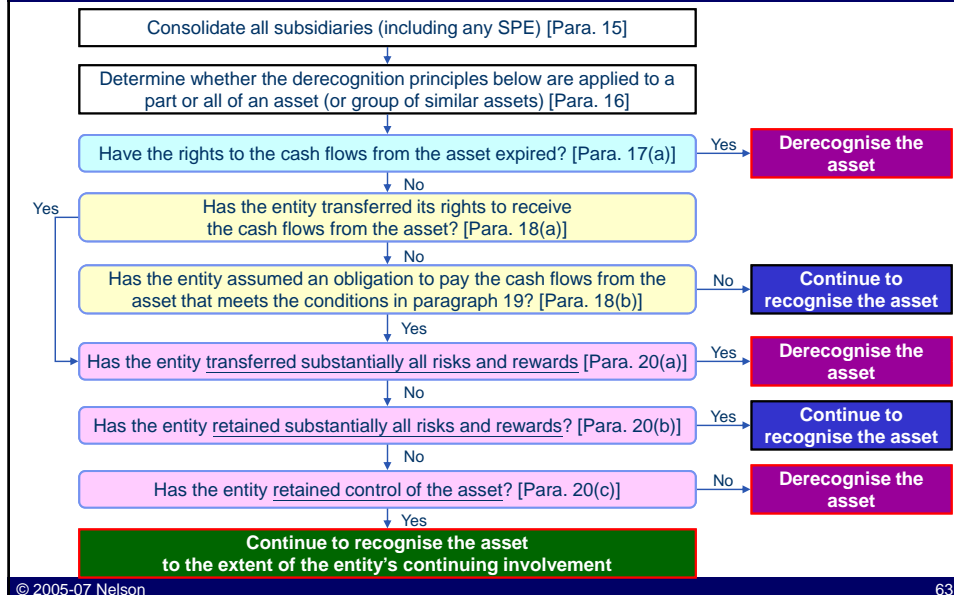
- a) the contractual rights to the cash flows from the financial asset expire; or
- b) it transfers the financial asset, and the transfer qualifies for derecognition



General principles

- If passing both Further Tests ⇒ derecognise the asset
- If not passing Asset Transfer Test ⇒ not derecognise the asset
- If passing the Asset Transfer Test, but not passing Risk and Reward test ⇒ consider the entity's control over the asset, and extent of continuing involvement

Derecognition of Financial Assets



Derecognition of Financial Assets

Case 8

Ping An Insurance (Group) Co. of China, Ltd.



Accounting report 2006

Derecognition of financial assets

- A financial asset (or, when applicable a part of a financial asset or part of a group of similar financial assets) is derecognized when:
 - the rights to receive cash flows from the asset have expired;
 - the Group retains the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a 'pass-through' arrangement; or
 - the Group has transferred its rights to receive cash flows from the asset and either:
 - has transferred substantially all the risks and rewards of the asset, or
 - has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

Derecognition of Financial Assets

Case 8

Ping An Insurance (Group) Co. of China, Ltd.



- Accounting report 2006

Derecognition of financial assets

- When the Group has transferred its right to receive cash flows from an asset and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset,
 - the asset is recognized to the extent of the Group's continuing involvement in the asset.
- Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of
 - the original carrying amount of the asset and
 - the maximum amount of consideration that the Group could be required to repay.

Derecognition of Financial Assets

Case 8

Ping An Insurance (Group) Co. of China, Ltd.



- Accounting report 2006

Derecognition of financial assets

- When continuing involvement takes the form of a written and/or purchased option (including a cash settled option or similar provision) on the transferred asset,
 - the extent of the Group's continuing involvement is the amount of the transferred asset that the Group may repurchase,
 - except that in the case of a written put option (including a cash settled option or similar provision) on an asset measured at fair value, the extent of the Group's continuing involvement is limited to the lower of
 - the fair value of the transferred asset and
 - the option exercise price.

Derecognition of Financial Assets

Example 3

- a) an unconditional sale of a financial asset;
- b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
- c) a sale of a financial asset together with a put or call option that is deeply out of the money (i.e. an option that is so far out of the money it is highly unlikely to go into the money before expiry).

- a) a sale & repurchase transaction where the repurchase price is a fixed price or a sale price plus a lender's return;
- b) a securities lending agreement
- c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity
- d) a sale of a financial asset together with a deep in-the-money put/call option
- e) a sale of short-term receivables in which the entity guarantees to compensate the buyer for any credit losses

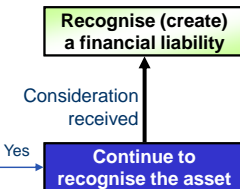
Has the entity transferred substantially all risks and rewards [Para. 20(a)]

Has the entity retained substantially all risks and rewards? [Para. 20(b)]

Derecognition of Financial Assets

- If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall
 - continue to recognise the transferred asset in its entirety
 - recognise a financial liability for the consideration received
 - in subsequent periods, recognise
 - any income on the transferred asset and
 - any expense incurred on the financial liability.

Has the entity retained substantially all risks and rewards? [Para. 20(b)]



Derecognition of Financial Assets

Case 9

2005/06 Annual Report:

- HKSA 39 provides more rigorous criteria for the derecognition of financial assets than the criteria applied in previous years.
- Under HKAS 39, a financial asset is derecognised, when and only when, either the contractual rights to the asset's cash flows expire, or the asset is transferred and the transfer qualifies for derecognition in accordance with HKAS 39. The decision as to whether a transfer qualifies for derecognition is made by applying a combination of risks and rewards and control tests
- The Company has applied the relevant transitional provision
- As a result, the Company's credit card receivables transferred to a special purpose entity under asset securitisation, which were derecognised prior to 20th February 2005, have not been restated.
- Any new transfer of credit card receivables to the SPE after 21st February 2005 has not been derecognised and remained as credit card receivables in the Company's financial statements.
 - This has resulted in a decrease in credit card securitisation income of HK\$23,700,000 in the current year.



Credit card receivable
↑ 106%

Turnover
↑ 4%

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Derecognition of Financial Assets

Case 10



• Accounting report 2006

Sales and repurchase agreements

- Securities sold under repurchase agreements represent short-term finance arrangements secured by the securities sold.
 - The securities remain on the balance sheet and a liability is recorded in respect of the consideration received.
 - Interest is calculated based upon the effective interest method.
- Conversely, securities purchased under resale agreements represent short-term investment arrangements secured by the securities purchased.
 - The securities are not recognised on the balance sheet and the consideration paid is recorded as an asset.
 - Interest is calculated based upon the effective interest method.
- Both securities sold under repurchase agreements and securities purchased under resale agreements are carried in the balance sheet at amortised cost.

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Derecognition of Financial Assets

Case 11

China Life Insurance Company Limited



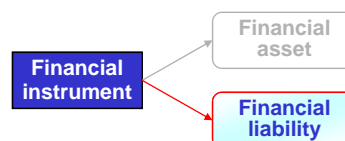
- Accounting report 2006

Securities sold with agreements to repurchase

- Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within 180 days from the transaction date.
- The Group may be required to provide additional collateral based on the fair value of the underlying securities.
- Securities sold under agreements to repurchase are recorded at their cost plus accrued interest at the balance sheet date.
- It is the Group's policy to maintain effective control over securities sold under agreements to repurchase which includes maintaining physical possession of the securities.
- Accordingly, such securities continue to be carried on the consolidated balance sheet.

Derecognition of Financial Liability

- An entity shall derecognise a financial liability (or part of a financial liability) when, and only when, it is extinguished i.e. obligation discharged or cancelled or expires
- An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as
 - an extinguishment of the original financial liability and
 - the recognition of a NEW financial liability.
- Similar accounting treatment is adopted for a substantial modification of the terms of an existing financial liability or a part of it
- The difference between
 - the carrying amount of a financial liability extinguished or transferred to another party and
 - the consideration paid, including any non-cash assets transferred or liabilities assumedshall be recognised in profit or loss.



Today's Agenda – Afternoon

Afternoon Session

Hedging



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Hedging – Introduction

A Hedge under IAS 39 involves 2 components

Hedging Instrument

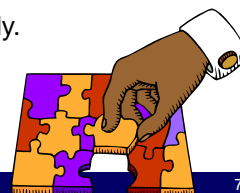
Hedged Item

- Strict conditions must be fulfilled before **Hedge Accounting** can be used.
- But even qualified, an entity can also choose not to use it, but

IAS 39 sets out **Hedge Accounting** which recognises the offsetting effects on profit or loss of changes in the fair values of these 2 components.

Hedge Accounting seeks to match the 2 sides of a **Hedging Relationship**, so as

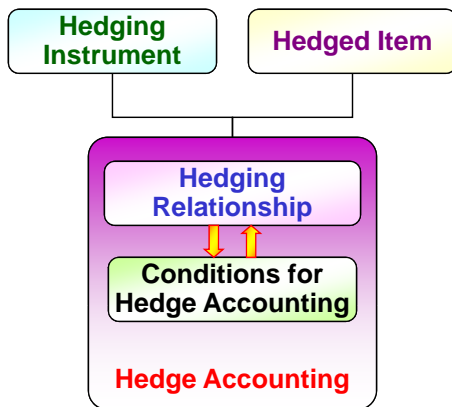
- to ensure both sides are offset and
- not to affect the income statements from one side only.



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Hedging – Introduction



IAS 39

- defines and restricts the items qualified as
 - Hedging Instruments and
 - Hedged Items
- Sets out the types of Hedge Relationship
- Requires Conditions for Hedge Accounting must be fulfilled to qualify a hedge accounting
- Sets out the Hedge Accounting

If there is a designated Hedging Relationship, accounting for gain or loss on the Hedging Instruments and Hedged Item shall follow Hedge Accounting.

Hedging – Introduction

Case 12

Annual Report 2005 (1st year in adopting HKAS 39 and HKFRS 4)

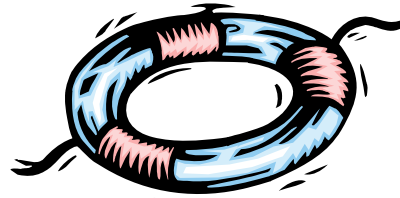
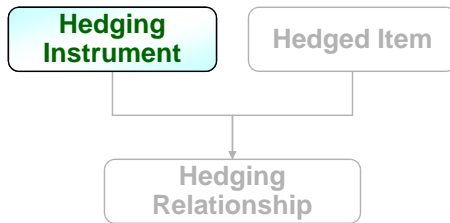
Change in accounting policy (HKAS 32 and 39) – Derivative financial instruments

- In prior years, the Group used derivative financial instruments such as foreign currency forward contracts, treasury lock agreements and cross currency swaps agreements to hedge risks associated primarily with foreign currency, interest rate and market fluctuations.
 - Derivative financial instruments were valued at fair value.
 - Any gain or loss was recognised in the income statement.
- Upon the adoption of HKAS 32 and HKAS 39, a cross currency swap agreement entered by the Group during the year and designated as a hedge against certain interest bearing loans was recorded at fair value.
 - The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity.

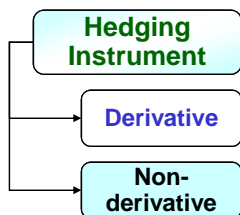


Conditions?

Hedging – Hedging Instruments



Hedging – Hedging Instruments



Hedging Instrument is

- a) a designated derivative, or
- b) a designated non-derivative financial asset or non-derivative financial liability (for a hedge of the risk of changes in **foreign currency exchange rates only**)

whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item

- A non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument **only for a hedge of a foreign currency risk**.
- **No restriction** on the circumstances in which a derivative may be designated as a hedging instrument provided the conditions for hedging accounting are met, **except for Some Written Options**.

Hedging – Hedging Instruments

Example 4

Entity A, whose functional currency is the Japanese yen

- has issued 5 million 5-year US\$ fixed rate debt.
 - owns a 5 million 5-year US\$ fixed rate bond which is classified as AFS.
1. Can Entity A designate its US\$ liability as a hedging instrument in a fair value hedge of the entire fair value exposure of its US\$ bond?
 2. Alternatively, can the US\$ liability be designated as a fair value hedge or cash flow hedge of the foreign currency component of the bond?

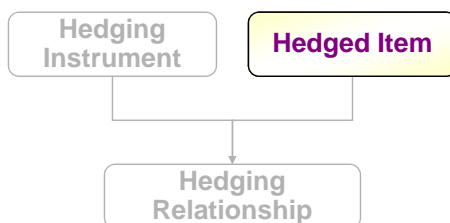
1. No.

- IAS 39 permits a non-derivative to be used as a hedging instrument only for a hedge of a foreign currency risk.
- Entity A's bond has a fair value exposure to:
 - foreign currency risk, interest rate changes and credit risk.

2. Yes

- However, hedge accounting is unnecessary because the amortised cost of the hedging instrument and the hedged item are both remeasured using closing rates.

Hedging – Hedged Item



Hedging – Hedged Item

Hedged item is

- an asset,
- a liability,
- a firm commitment,
- a highly probable forecast transaction, or
- a net investment in a foreign operation, that

exposes the entity to risk of changes in fair value or future cash flows and is designated as being hedged.

Hedged Item

- A hedged item is an exposure to risk to an entity that attempt to hedge.
- A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation.

Hedging – Hedged Item

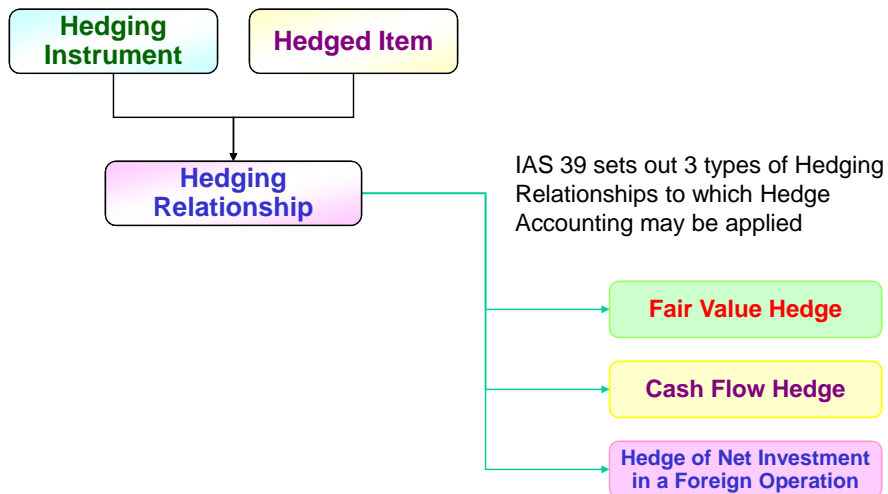
Example 5

- Is hedge accounting permitted for a currency borrowing that hedges an expected but not contractual revenue stream in foreign currency?

Yes, if the revenues are highly probable.

- Under IAS 39, a hedge of an anticipated sale (highly probable forecast transaction) may qualify as a Cash Flow Hedge.
- For example:
 - An airline entity may use sophisticated models based on experience and economic data to project its revenues in various currencies.
 - If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are “highly probable”, as required by IAS 39, it may designate a currency borrowing as a Cash Flow Hedge of the future revenue stream.
 - It is unlikely that it can reliably predict 100% revenues for a future year.
 - However, it is possible that a portion of predicted revenues, normally those expected in the short term, will meet the “highly probable” criterion.

Hedging – Hedge Relationship



Hedging – Hedge Relationship

Fair Value Hedge

A hedge of the exposure to changes in fair value of

- a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such items

that is attributable to a particular risk and could affect P/L

Cash Flow Hedge

A hedge of the exposure to variability in cash flows that

- is attributable to a particular risk associated with a recognised asset or liability, or a highly probable forecast transaction and
- could affect profit or loss

A hedge of the foreign currency risk of a firm commitment may be accounted for

- as a fair value hedge or as a cash flow hedge

Hedge of Net Investment in a Foreign Operation

Hedge of a net investment in a foreign operation is as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates*

Hedging – Hedge Relationship

Example 6

Fair Value Hedge

Cash Flow Hedge

Hedge of Net Investment
in a Foreign Operation

Determine the classification for the following hedge:

- Entity A has a floating rate bond and enters into an interest rate swap by receiving fixed and paying float
- Entity B has a fixed rate bond and enters into an interest rate swap by receiving float and paying fixed
- Entity C issues a floating rate bond and enters into an interest rate swap by paying fixed and receiving float
- Entity D issues a floating rate bond and buys an interest rate cap

Hedging – Hedge Relationship

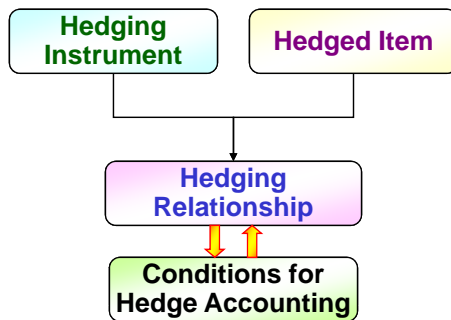
Case 13

Annual Report 2006

- Derivatives Financial Instruments and Hedging
 - For the purpose of hedge accounting, hedges are classified as cash flow hedges when hedging the exposure to variability in cash flows that is either attributable to
 - a particular risk associated with
 - a recognised asset or liability or
 - a highly probable forecast transaction or
 - a foreign currency risk in an unrecognised firm commitment.



Hedging – Hedge Accounting Conditions



A **Hedging Relationship** qualifies for **Hedge Accounting** if and only if all the **Conditions for Hedge Accounting** are met

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Hedging – Hedge Accounting Conditions

All 5 **Conditions for Hedge Accounting** must be met:

Formal documentation at inception

Highly effective and consistent with originally documented risk

Forecasted transaction to be highly probable (for cash flow hedge)

Hedge effectiveness can be reliably measured

Ongoing-assessed and actually highly effective

Conditions for Hedge Accounting

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Hedging – Hedge Accounting Conditions

Formal documentation
at inception

- At the inception of the hedge, there is formal designation and documentation of:
 - the hedging relationship and
 - the entity's risk management objective and strategy for undertaking the hedge.
- That documentation shall include:
 - identification of the hedging instrument,
 - the hedged item or transaction,
 - the nature of the risk being hedged and
 - how the entity will assess
 - the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

Hedge
Effectiveness

Hedging – Hedge Accounting Conditions

Forecasted transaction
to be highly probable
(for cash flow hedge)

For Cash Flow Hedges,

- a forecast transaction that is the subject of the hedge
 - must be highly probable and
 - must present an exposure to variations in cash flows that could ultimately affect profit or loss.

Hedging – Hedge Accounting Conditions

Measurable and highly effective hedge from the beginning to the end

Highly effective and consistent with originally documented risk

The hedge is **expected** to be **highly effective** in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, **consistently with the originally documented risk management strategy** for that particular hedging relationship.

Hedge effectiveness can be reliably measured

The effectiveness of the hedge can be reliably measured, i.e. *the fair value or cash flows of the hedged item* that are attributable to the hedged risk and *the fair value of the hedging instrument* can be reliably measured.

Ongoing-assessed and actually highly effective

The hedge is assessed on an **ongoing basis** and determined **actually** to have been highly effective throughout the financial reporting periods for which the hedge was designated.

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Hedging – Hedge Accounting Conditions

Case 14

Annual Report 2006

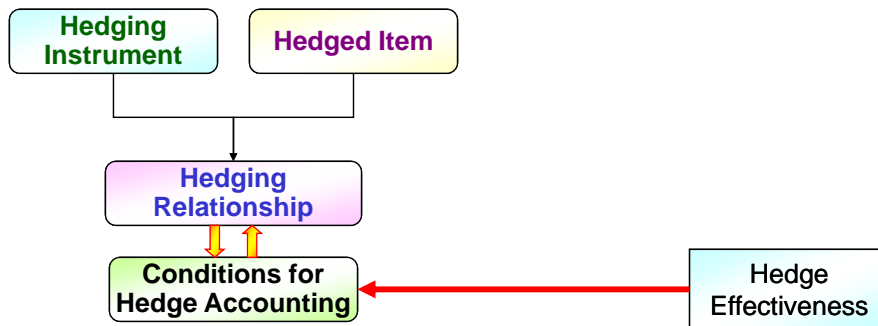
- Derivatives Financial Instruments and Hedging
 - At the inception of a hedge relationship, the Group formally designates and documents
 - the hedge relationship to which the Group wishes to apply hedge accounting and
 - the risk management objective and strategy for undertaking the hedge.
 - The documentation includes
 - identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the Group will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
 - Such hedges are expected to be highly effective in achieving offsetting changes in fair value or cash flows and are assessed on an ongoing basis to determine that they actually have been highly effective throughout the financial reporting periods for which they were designated.



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Hedging – Assess Hedge Effectiveness



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Hedging – Assess Hedge Effectiveness

- **Hedge effectiveness** is the degree to which
 - *changes in the fair value or cash flows of the hedged item* that are *attributable to a hedged risk*
 - are offset by *changes in the fair value or cash flows of the hedging instrument*.

Hedge Effectiveness

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Hedging – Assess Hedge Effectiveness

A hedge is regarded as **highly effective** only if both of the following conditions are met:

Inception and Ongoing

Prospective testing

- a) At the inception of the hedge and in subsequent periods
- the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated.

Actual results

Retrospective testing

- b) The actual results of the hedge are within a range of 80% – 125%.

Effectiveness is assessed, at a minimum, at the time an entity prepares its

- annual financial statements or
- interim financial statements.

Hedging – Assess Hedge Effectiveness

Inception and Ongoing

Prospective testing

In some cases, matching critical terms is also allowed

- Such expectation (at the inception and in subsequent periods) can be demonstrated in various ways, including:
 - a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument (i.e. analysis of historical data), or
 - by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument (i.e. using statistical model, say regression analysis).
- The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge (as described in IAS 39.AG100).

Hedging – Assess Hedge Effectiveness

- The actual hedge effectiveness measurement may be based on either:
 - A period by period basis, or
 - A cumulative basis
- Such basis should be established in the hedge documentation and properly followed afterward.
- If a cumulative basis is used, hedge accounting will not be ceased even the hedge is not effective for a particular period.

Actual results

b) The actual results of the hedge are within a range of 80% – 125%.

Retrospective testing

Hedging Instrument

→ Gain is \$125

Hedged Item

→ Loss is \$100

- The degree of offset can be measured by either
 - $\$125 \div \100 , which is 125%, or
 - $\$100 \div \125 , which is 80%

within 80% to 125% range

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Hedging – Assess Hedge Effectiveness

Case 15



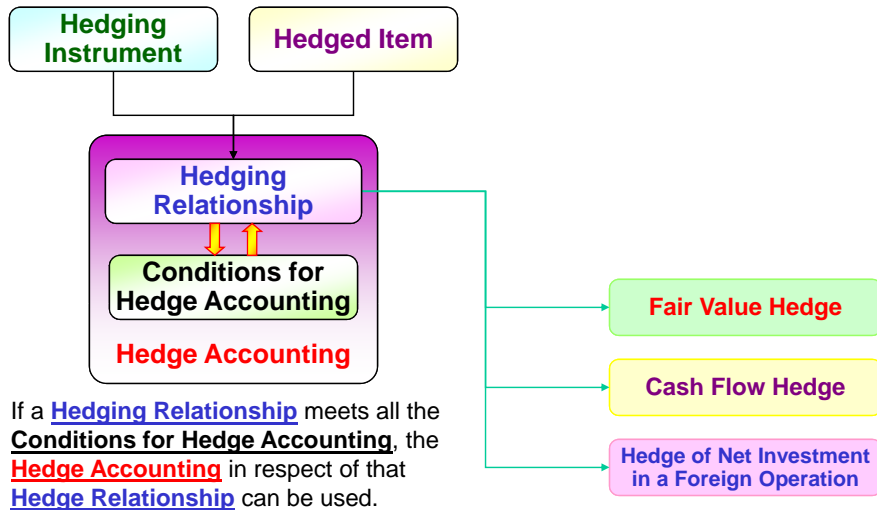
2005 Annual Financial Statements

- To qualify for hedge accounting, HSBC requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness). Actual effectiveness (retrospective effectiveness) must also be demonstrated on an ongoing basis.
- The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method an HSBC entity adopts for assessing hedge effectiveness will depend on its risk management strategy.
- For prospective effectiveness,
 - the hedging instrument must be expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated.
- For actual effectiveness,
 - the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent for the hedge to be deemed effective.
- Hedge ineffectiveness is recognised in the income statement in 'Net trading income'.

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Hedging – Hedge Accounting



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Hedging – Hedge Accounting

Fair Value Hedge

⇒ Meets the **Condition for Hedging Accounting**, then:

Hedging Instrument

Hedged Item

- a) the gain or loss from re-measuring the **Hedging Instrument** at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with IAS 21 (for a non-derivative hedging instrument)
 - shall be recognised in profit or loss
- b) the gain or loss on the **Hedged Item** attributable to the hedged risk
 - shall adjust the carrying amount of the **Hedged Item** and be recognised in profit or loss.

This applies if the hedged item is otherwise measured at cost.

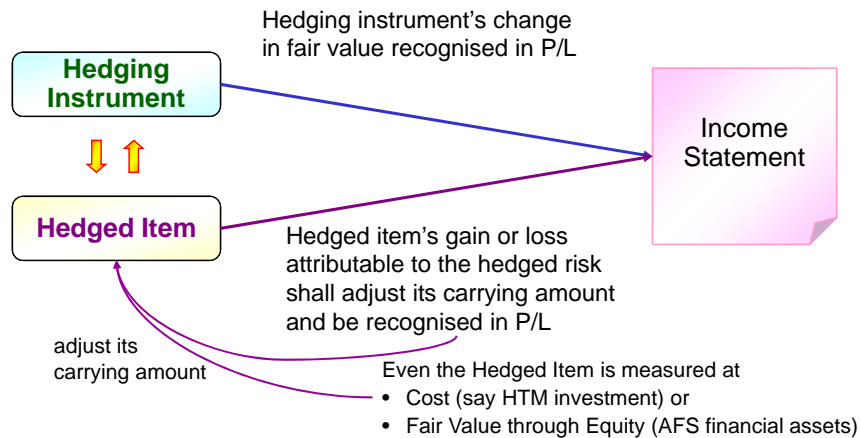
Recognition of the gain or loss attributable to the hedged risk in P/L applies if the hedged item is an available-for-sale financial asset.

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Hedging – Hedge Accounting

Fair Value Hedge



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Hedging – Hedge Accounting

Example 7

Interest Rate Swap on A Fixed Rate Financial Asset

- Company A purchases a bond that
 - has a principal amount of \$1 million at a fixed interest rate of 6% per year.
 - is classified as an available-for-sale financial asset.
 - has a fair value of \$1 million.
- The company enters into an interest rate swap.
 - It exchanges the fixed interest rate payments it receives on the bond for floating interest rate payments, in order to offset the risk of a decline in fair value.
 - It designates and documents the swap as a hedging instrument.
 - The swap has a fair value of zero at the inception of hedge.
- Assuming
 - The market interest rates have increased to 7% and the fair value of the bond will have decreased to \$960,000.
 - The fair value of the swap has increased by \$40,000.

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Hedging – Hedge Accounting

Example 7

- The instrument is classified as available-for-sale, therefore the decrease in fair value would normally be recorded directly in reserves.
- However, since the instrument is a Hedged Item in a Fair Value Hedge, this change in fair value of the instrument is recognised in profit or loss, as follows:

Dr Income statement \$40,000
 Cr Available-for-sale financial asset \$40,000

- While the swap is a derivative, it is measured at fair value with changes in fair value recognised in profit or loss.

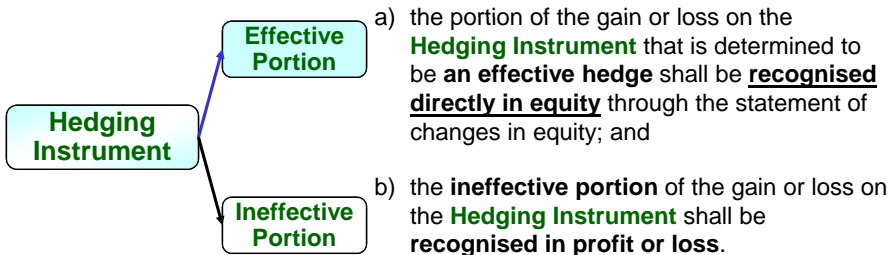
Dr Swap receivables \$40,000
 Cr Income statement \$40,000

- The changes in fair value of the Hedged Item and the Hedging Instrument exactly offset each other:
 - the hedge is 100% effective and the net effect on profit or loss is zero.

Hedging – Hedge Accounting

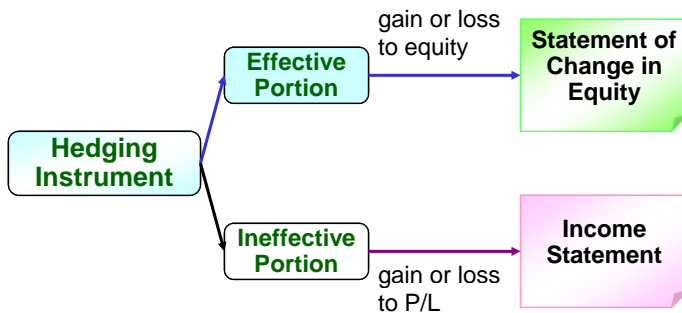
Cash Flow Hedge

⇒ Meets the **Condition for Hedging Accounting**, then:



Hedging – Hedge Accounting

Cash Flow Hedge



How's the treatment, if it is

Hedge of a forecast transaction resulting in recognition of **Financial Asset or Financial Liability**

Hedge of forecast transaction resulting in recognition of **Non-Financial Asset or Non-Financial Liability**

Hedging – Hedge Accounting

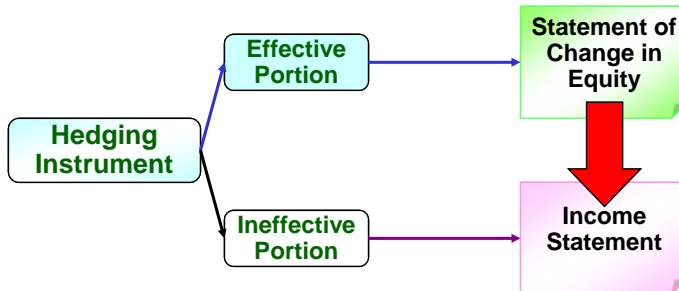
Cash Flow Hedge

- If a **Hedge of a Forecast Transaction** subsequently results in the recognition of a **financial asset or a financial liability**
 - the associated gains or losses that were recognised directly in equity shall be reclassified into profit or loss in the same period(s) during which the asset acquired or liability assumed affects profit or loss (such as in the periods that interest income or interest expense is recognised)
- If any loss recognised directly in equity is expected not to be recovered in one or more future periods
 - it shall reclassify such loss into profit or loss.

Hedge of a forecast transaction resulting in recognition of **Financial Asset or Financial Liability**

Hedging – Hedge Accounting

Cash Flow Hedge



Hedge of a forecast transaction resulting in recognition of **Financial Asset or Financial Liability**

- Reclassified associated gain or loss recognised in equity to P/L in case of
- Final recognition of financial assets or financial liabilities, or
 - Loss recognised directly in equity is expected not to be recovered

Hedging – Hedge Accounting

Cash Flow Hedge

- If a **Hedge of a Forecast Transaction** subsequently results in
 - the recognition of a non-financial asset or a non-financial liability, or
 - a forecast transaction for such non-financial item becomes a firm commitment for which fair value hedge accounting is applied
- Then an entity shall adopt (a) or (b) below:

a) Reclassifies the associated gains and losses recognised in equity into P/L in the same period(s) during which the asset acquired or liability assumed affects P/L (such as in the periods that depreciation expense or cost of sales is recognised).
If any loss recognised directly in equity is expected not to be recovered in one or more future periods, it shall reclassify into P/L such loss.

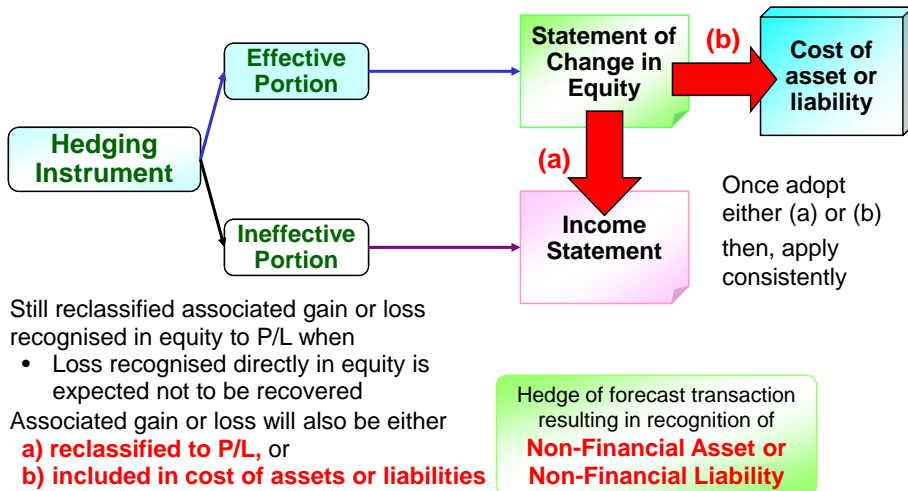
b) Removes the associated gains and losses recognised directly in equity, and includes them in the initial cost or other carrying amount of the asset or liability.

Once adopt either (a) or (b), apply consistently

Hedge of forecast transaction resulting in recognition of **Non-Financial Asset or Non-Financial Liability**

Hedging – Hedge Accounting

Cash Flow Hedge



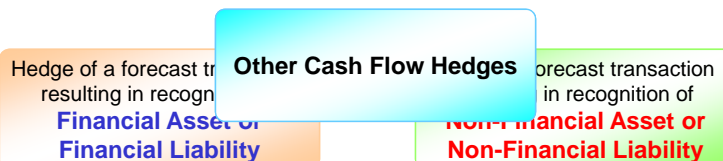
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Hedging – Hedge Accounting

Cash Flow Hedge

- For cash flow hedges other than those discussed
 - amounts that had been recognised directly in equity shall be recognised in profit or loss in the same period(s) during which the hedged forecast transaction affects P/L (for example, when a forecast sale occurs).

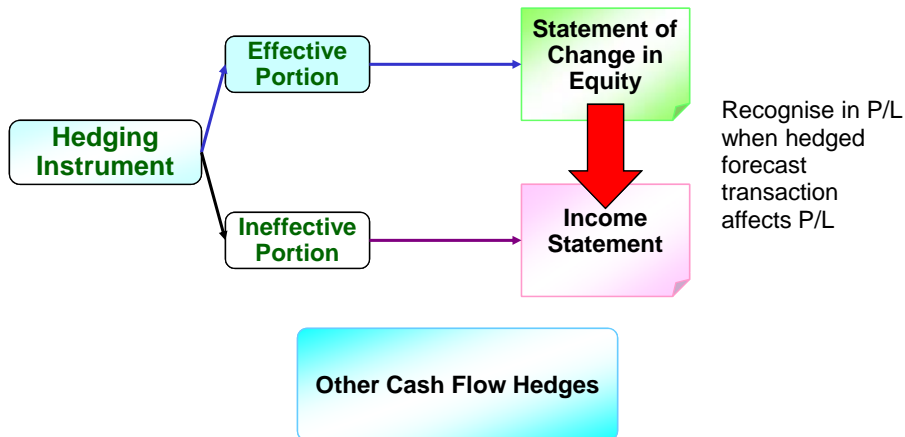


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Hedging – Hedge Accounting

Cash Flow Hedge



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Hedging – Hedge Accounting

Case 16



- Accounting report 2005 (1st year in adopting HKAS 39 and HKFRS 4)

- In prior years, derivative financial instruments entered into by management to hedge the interest rate risk of a recognised asset or liability or the foreign currency risk of a committed future transaction were recognised on an accruals basis with reference to the timing of recognition of the hedged transaction.
- With effect from 1 January 2005, and in accordance with HKAS 39, all derivative financial instruments entered into by the Group are stated at fair value.
 - Changes in the fair value of derivatives held as hedging instruments in a cash flow hedge are recognised in equity to the extent that the hedge is effective and until the hedged transaction occurs.
 - Any other changes in fair value of the derivatives are recognised in the income statement.

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Hedging – Hedge Accounting

Example 8

Hedge of Forecast Transaction

- Entity A trades in UK mainly in UK Sterling.
 - It expects to purchase a machine for 1 million Euros in one year from 1 May 2006.
 - In order to offset the risk of increases in the Euro rate, Entity A enters into a forward contract to purchase 1 million Euros in 1 year for a fixed amount (£650,000).
 - The forward contract is designated as a Cash Flow Hedge.
 - At inception, the forward contract has a fair value of zero.
- At the year-end of 31 October 2006
 - the Euro has appreciated and the value of 1 million Euros is £660,000.
 - The fair value of the forward contract rises to £10,000.
 - The machine will still cost 1 million Euros so the company concludes that the hedge is 100% effective.

Hedging – Hedge Accounting

Example 8

- The entire change in the fair value of the hedging instrument is recognised directly in reserves.

Dr Forward contract	£10,000	
Cr Reserves		£10,000
- The forward contract is settled with no further change in the exchange rate:

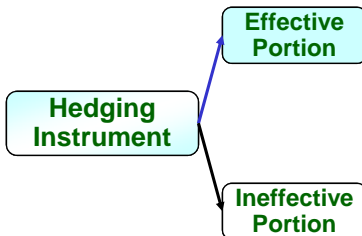
Dr Cash	£10,000	
Cr Forward contract		£10,000
- The company purchases the machine for 1 million euros and makes the following journal entry:

Dr Machine	£660,000	
Cr Accounts Payable		£660,000
- The gain of £10,000 recognised in reserve (equity) should either
 - be reclassified from equity into P/L, or
 - be reclassified from equity and included in the initial carrying amount of the machine (for non-financial assets or liabilities only)
 - once this policy is chosen, it must be used consistently

How to treat this amount finally?

Hedging – Hedge Accounting

Hedge of Net Investment in a Foreign Operation



Including a hedge of a monetary item that is accounted for as part of the net investment, shall be accounted for similarly to **Cash Flow**

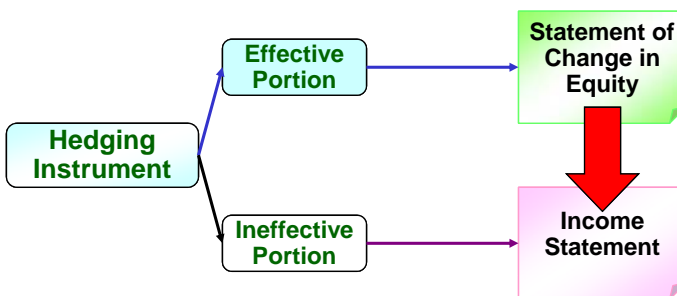
Hedges:

- a) the portion of the gain or loss on the **Hedging Instrument** that is determined to be an **effective hedge** shall be **recognised directly in equity** through the statement of changes in equity; and
- b) the **ineffective portion** shall be **recognised in profit or loss**.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised directly in equity shall be recognised in profit or loss on disposal of the foreign operation.

Hedging – Hedge Accounting

Hedge of Net Investment in a Foreign Operation



Recognise in P/L on disposal of the foreign operation

Hedge – Cease Hedge Accounting

An entity shall discontinue prospectively the **Hedge Accounting** if:

- a) the hedging instrument expires or is sold, terminated or exercised;
- b) the hedge no longer meets the **Conditions for Hedge Accounting**;
- c) the entity revokes the designation; or
- d) in case of a **Cash Flow Hedge**, the forecast transaction that is hedged is no longer expected to occur.

When the **Hedge Accounting** is discontinued (for **Cash Flow Hedge**), the cumulative gain or loss on the **Hedging Instrument** that remains recognised directly in equity shall:

- a) remain separately recognised in equity until the forecast transaction occurs; or
- b) be recognised in profit or loss if the forecast transaction is no longer expected to occur.

Hedge

Case 17

Annual Report 2006

- Derivatives Financial Instruments and Hedging
 - Cash flow hedges which meet the strict criteria for hedge accounting are accounted for as follows:
 - The effective portion of the gain or loss on the hedging instrument is recognised directly in equity, while the ineffective portion is recognised immediately in the income statement;
 - Amounts taken to equity are transferred to the income statement when the hedged transaction affects the income statement, such as when hedged financial income or financial expense is recognised or when a forecast sale or purchase occurs; and
 - If the forecast transaction or firm commitment is no longer expected to occur, the amounts previously recognised in equity are transferred to the income statement. If the hedging instrument expires or is sold, terminated or exercised without replacement or rollover, or if its designation as a hedge is revoked, the amounts previously recognised in equity remain in equity until the forecast transaction or firm commitment occurs.



Today's Agenda – Afternoon

Afternoon Session

FI: Presentation



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Presentation and Disclosure

IAS 32 *Financial Instruments: Disclosure and Presentation*

- Aims at enhancing financial statement users' understanding of
 - the significance of financial instruments to an entity's financial position, performance and cash flows.
- Contains requirements for the presentation of financial instruments and identifies the information that should be disclosed about them.

From
1.1.2007

IAS 32 *Financial Instruments: Presentation*

- Aims at establishing principles
 - for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities.

IFRS 7 *Financial Instruments: Disclosures*

- Aims at providing disclosures to evaluate the significance of financial instruments and the nature and extent of risks arising from financial instruments

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IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

Treasury shares

Interests, dividends, losses and gains

- The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as
 - a financial liability,
 - a financial asset or
 - an equity instrumentin accordance with
 - the substance of the contractual arrangement and
 - the definitions of a financial liability, a financial asset and an equity instrument. (*assess the substance*)

IAS 32 – Presentation

Case 18



Annual report of 2005 sets out that it has probably had the following shares:

- Preference shares carry a mandatory coupon
- Preference shares are redeemable on a specific date or at the option of the shareholder
- Preference shares are redeemable at the option of the shareholder

How do you classify and present the above items?

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Contractual obligation, including one arising from a derivative, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

- An instrument can be an equity instrument if, and only if, both conditions (a) and (b) below are met.
 - a) The instrument includes no contractual obligation:
 - i) to deliver cash or another financial asset; or
 - ii) to exchange financial instrument under conditions that are potentially unfavourable to the issuer.
 - b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
 - i) a non-derivative that includes no contractual obligation to deliver a variable no. of its own equity instruments; or
 - ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

- b) Settled in the Entity's Own Equity Instruments**
 - A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments.
- a) Contract to receive or deliver a variable no. of its own equity
 - so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation
 - is a financial liability even though the entity must or can settle it by delivering its own equity instruments.

IAS 32 – Presentation

Example 9

Presentation from the perspective of the issuer on

Liability and equity

- Are the following financial liabilities or equity instruments?
 - A contract to deliver as many of the entity's own equity instruments as are equal in value to \$10,000. ➤ Financial liability
 - A contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 ounces of gold. ➤ Financial liability
- Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments.
 - It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract.

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

b) Settled in the Entity's Own Equity Instruments

- b) Contract to purchase its own equity for cash or another financial asset
 - give rise a financial liability for the present value of the redemption amount
 - A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments.
- c) Contract to receive or deliver a fixed no. of its own equity
 - If in exchange for a variable amount of cash or another financial asset
 - The contract is a financial asset or financial liability
 - Example:
 - a contract for the entity to deliver 100 of its own equity instruments in return for an amount of cash calculated to equal the value of 100 ounces of gold.

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Contingent Settlement Provisions

- Such instrument may require the entity to deliver cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) under a condition that are beyond the control of both the issuer and the holder of the instrument
 - such as a change in a stock market index, or the issuer's future revenues, net income or debt-to-equity ratio.
- Implies no unconditional right to avoid delivering cash or another financial asset
- Therefore, it is a financial liability of the issuer unless:
 - a) the part of the contingent settlement provision that could require settlement in cash or another financial asset is not genuine; or
 - b) the issuer can be required to settle the obligation in cash or another financial asset only in the event of liquidation of the issuer.

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Settlement Options

- When a derivative financial instrument gives one party a choice over how it is settled
 - e.g. the issuer or the holder can choose settlement net in cash or by exchanging shares for cash)
- It is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.
- An example of a derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash.

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

Compound financial instrument is an instrument containing both a liability and an equity component

- IAS 32
 - applies only to issuers of non-derivative compound financial instruments and
 - does not deal with compound financial instruments from the perspective of holders.
- IAS 39
 - deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain debt and equity features.

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

Evaluation and Initial Classification

- The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instruments
 - to determine whether it contains both a liability and an equity component.
- Such components shall be classified separately as financial liabilities, financial assets or equity instrument in accordance with
 - the substance of the contractual arrangement and
 - the definitions of a financial liability, financial asset and an equity instrument.
- An entity recognises separately the components of a financial instrument that
 - a) creates a financial liability of the entity, and
 - b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity.



IAS 32 – Presentation

Example 10

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments



- For example, a convertible bond allows the bondholder to convert it into a fixed no. of ordinary shares of the entity
 - is a compound financial instrument.
- From the perspective of the entity, such an instrument comprises two components:
 - 1) a financial liability – a contractual arrangement to deliver cash or another financial asset), and
 - 2) an equity instrument – a call option granting the holder the right, for a specified period of time, to convert it into a fixed no. of ordinary shares of the entity.
- The economic effect of issuing such an instrument is substantially the same as issuing a debt instrument with detachable share purchase warrants.
- In all cases, the entity presents the liability and equity components separately on its balance sheet.

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments



Not Revised Subsequently

- Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised,
 - even when exercise of the option may appear to have become economically advantageous to some holders.

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments



Separating Initial Carrying Amount of Each Component

- The equity component is assigned the **residual amount**, after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component.
- The value of any derivative features (such as a early redemption option) embedded in the compound financial instrument other than the equity component
 - is included in the liability component.
- The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole.
- No gain or loss arises from initially recognising the components of the instrument separately.

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IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments



Separating Initial Carrying Amount of Each Component

The issuer of a bond convertible into ordinary shares

- Firstly determines the carrying amount of the liability component
 - by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component.
- Then determine the carrying amount of the equity instrument represented by the option to convert the instrument into ordinary shares
 - by deducting the fair value of the financial liability
 - from the fair value of the compound financial instrument as a whole.

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IAS 32 – Presentation

Example 11

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

For example, an entity issues a 5% 5-year convertible bond

- It can be analysed as

$$\boxed{\text{5\% Convertible Bond}} = \boxed{\text{5\% 5-year Bond}} + \boxed{\text{an Option (to convert shares)}}$$

Liability

Equity

- To find out the equity component:

$$\boxed{\text{5\% Convertible Bond}} - \boxed{\text{5\% 5-Yr Bond}} = \boxed{\text{Option}}$$

Cash received

Use DCF method
(liability component)

Residual

- To classify as Equity

IAS 32 – Presentation

Example 12

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

- An entity issues 2,000 convertible bonds at the start of year 1.
- The bonds have a 3-year term, and are issued at par with a face value of \$1,000 per bond, giving total proceeds of \$2,000,000.
- Interest is payable annually in arrears at a nominal annual interest rate of 6%.
- Each bond is convertible at any time up to maturity into 250 ordinary shares.
- When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%.
- Discuss and calculate in accordance with IAS 32.

IAS 32 – Presentation

Example 12

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

- The liability component is measured first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component.
- The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights.

Present value of the principal		
\$2,000,000 payable at the end of three years	\$	1,544,367
Present value of the interest		
\$120,000 payable annually in arrears for three years		<u>303,755</u>
Total liability component	\$	1,848,122
Equity component (by deduction)		<u>151,878</u>
Proceeds of the bond issue	\$	2,000,000

IAS 32 – Presentation

Example 13

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

How does an issuer recognise a callable convertible bond?

- Assume that the proceeds received on the issue of a callable convertible bond are \$60.
- The value of a similar bond without a call or equity conversion option is \$57.
- Based on an option pricing model, it is determined that the value to the entity of the embedded call feature in a similar bond without an equity conversion option is \$2.

- In this case, the value allocated to the liability component is \$55 (\$57 – \$2).
- Then, the value allocated to the equity component is \$5 (\$60 – \$55).
- The journal entry is as follows:

Dr	Cash	60	
Cr	Liabilities		55
	Equity		5

2 components:

- Liability component, plus
- Derivative feature embedded other than the equity component (i.e. the call feature)

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

Treasury shares

- Treasury shares (an entity's own equity instruments reacquired by itself or its subsidiaries)
 - Those instruments shall be deducted from equity
 - Cannot be classified as an asset
 - No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments.
 - Such treasury shares may be acquired and held by the entity or by other members of the consolidated group.
 - Consideration paid or received shall be recognised directly in equity.
- The amount of treasury shares held is disclosed separately either on the face of the balance sheet or in the notes.

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

Treasury shares

Interests, dividends, losses and gains

- Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability
 - shall be recognised as income or expense in profit or loss.
- Distributions to holders of an equity instrument
 - shall be debited by the entity directly to equity, net of any related income tax benefit.
- Transaction costs of an equity transaction, other than costs of issuing an equity instrument that are directly attributable to the acquisition of a business,
 - shall be accounted for as a deduction from equity, net of any related income tax benefit.

IAS 32 – Presentation

Case 19



Annual report of 2005 sets out that:

- Preference shares, which
 - carry a mandatory coupon,
 - or are redeemable on a specific date
 - or at the option of the shareholder,are classified as financial liabilities and are presented in other borrowed funds.
- The dividends on these preference shares
 - are recognised in the income statement as interest expense on an amortised cost basis using the effective interest method.

IAS 32 – Presentation

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

Treasury shares

Interests, dividends, losses and gains

- In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see derecognition in IAS 39).

Offsetting

Financial assets and financial liabilities are offset when and only when

- 1) there is a legally enforceable right to set off, and
- 2) the entity intends to settle on a net basis

IAS 32 – Disclosure (Replaced)

IAS 32 also requires extensive disclosures

Liability and equity

Compound financial instruments

Treasury shares

Interests, dividends, losses and gains

Disclosure

- Risk management policies and hedging activities
- Terms, condition and accounting policies
- Interest rate risk
- Credit risk
- Fair value (for the instrument not carried at fair value)
- Other disclosures (including derecognition, collateral, effect on income statement and equity, reclassification, impairment, and etc)

Offsetting

Financial assets and financial liabilities are offset when and only when

- 1) there is a legally enforceable right to set off, and
- 2) the entity intends to settle on a net basis

Today's Agenda – Afternoon

Afternoon Session



FI: Disclosure

Disclosure Amended by IFRS 7

- The objective of IFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

1) the significance of financial instruments for the entity's

- financial position and
- financial performance; and

Significance

- Balance sheet
- Income statement
- Other disclosures

2) the nature and extent of risks arising from financial instruments to which the entity is exposed

- during the period and
- at the reporting date, and

how the entity manages those risks.

Nature and Extent

- Qualitative disclosures
- Quantitative disclosures

Disclosure Amended by IFRS 7

- IFRS 7 supersedes (from 1 Jan. 2007)
 - Full IAS 30
 - Para. 51 to 95 of IAS 32
- As compared with IAS 30 and 32, IFRS 7 has the following attributes:

1. Apply to all entities while IAS 30 applies to financial institution only
2. Is more correlation with the categories of financial instruments as defined in IAS 39
3. Aim at simplifying the disclosure requirements of IAS 32 on risks but introduced some new disclosures
4. IAS 32 has exemption for comparative on first year of adoption but IFRS 7 only provides exemption on the nature and extent of risks.

Significance

Nature and Extent

1. Significance of Financial Instruments

Significance

- An entity shall disclose information that enables users of its financial statements to evaluate
 - the significance of financial instruments for its financial position and performance.

Balance Sheet

Income Statement

Other Disclosures



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2. Nature and Extent of Risks

Nature and Extent

- An entity shall disclose information that enables users of its financial statements to evaluate
 - the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.
- The disclosures required focus on the risks that arise from financial instruments and how they have been managed.
- These risks typically include, but are not limited to
 - credit risk,
 - liquidity risk and
 - market risk.

Currency risk, interest rate risk and other price risk



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2. Nature and Extent of Risks

Nature and Extent

In IAS 32

Market Risk

Currency Risk

FV Interest
Rate Risk

Price Risk

Credit Risk

Liquidity Risk

Cash Flow Interest
Rate Risk

In IFRS 7

Market Risk

Currency Risk

Interest
Rate Risk

Other Price Risk

Credit Risk

Liquidity Risk

2. Nature and Extent of Risks

Nature and Extent

Qualitative Disclosures

- For each type of risk arising from financial instruments, an entity shall disclose:
 - a) The exposures to risk and how they arise;
 - b) Its objectives, policies and processes for managing the risk and the methods used to measure the risk
 - c) Any changes in (a) or (b) from the previous period.



2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures



- For each type of risk arising from financial instruments, an entity shall disclose:
 - Summary quantitative data about its exposure to that risk at the reporting date.
- The level of detail of such disclosure is based on:
 - The information provided internally to key management personnel of the entity (as defined in IAS 24 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.
- If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

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2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Credit risk

- An entity shall disclose by class of financial instrument:
 - a) the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (e.g. netting agreements that do not qualify for offset in accordance with IAS 32);
 - b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancements;
 - c) information about the credit quality of financial assets that are neither past due nor impaired; and
 - d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

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2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Credit risk

- For financial assets that are either past due or impaired, an entity shall disclose by class of financial asset:
 - a) an analysis of the age of financial assets that are past due as at the reporting date but not impaired;
 - b) an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired; and
 - c) for the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.



2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Liquidity risk

- An entity shall disclose:
 - a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and
 - b) a description of how it manages the liquidity risk inherent in (a).



2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Market risk

- IFRS 7 requires the disclosures of sensitivity analysis.
- The disclosures of sensitivity analysis can be achieved by 2 approaches:
 1. Sensitivity analysis for each type of market risk
 2. Sensitivity analysis that reflects interdependencies between risks variables



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2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Market risk – Sensitivity Analysis for Each Type of Market Risk

- An entity shall disclose:
 - a) a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing:
 - how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
 - b) the methods and assumptions used in preparing the sensitivity analysis; and
 - c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

Currency risk,
interest rate risk and
other price risk



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2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Market risk – Sensitivity analysis that reflects interdependencies between risks variables

- Alternatively, an entity prepares and discloses a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g. interest rates and exchange rates) and uses it to manage financial risks.
- The entity shall also disclose:
 - a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and
 - b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

2. Nature and Extent of Risks

Case 20

- Early adopted HKFRS 7 in 2005 and its annual report states that (extract only):
 - Risk management techniques, such as Value-at-Risk (“VaR”) based on historical simulation and portfolio stress testing, are used to identify, measure and control foreign exchange risk, equity price risk and interest rate risks of the Group’s investments.
 - VaR measures the expected maximum loss over a given time interval (a holding period of 10 trading days is used by the Group) at a given confidence level (95 per cent confidence interval is adopted by the Group) based on historical data (one year is used by the Group).
 - The Board sets a limit on total VaR of the Group and VaR is monitored on a weekly basis



How would you determine them?

2. Nature and Extent of Risks

Case 20

- Early adopted HKFRS 7 in 2005 and its annual report states that (extract only):



- The VaR for each risk factor and the total VaR of the investments of the Group and HKEx during the year were as follows:

	Group			HKEx		
	2005			2005		
	Average \$million	Highest \$million	Lowest \$million	Average \$million	Highest \$million	Lowest \$million
Foreign exchange risk	5	6.1	3.6	0.2	0.7	-
Equity price risk	8.5	11.2	6.6	-	-	-
Interest rate risk	20.5	24	14.4	-	-	-
Total VaR	23.5	26.9	20.4	0.2	0.7	-

2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Other market risk disclosures

- When the sensitivity analyses disclosed (by the 2 approaches) are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year),
 - the entity shall disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

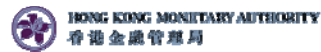


How Do You Determine Them

Case 21

Reference to the time horizon and confidence level of some entities used in VaR analysis

Entity name	Time horizon	Confidence level
• HSBC	• 1 day	• 99%
• BoC-HK	• 1 day	• 99%
• Standard Chartered	• 1 day	• 97.5%
• HKMA	• 1 month	• 95%
• HKEx	• 10 days	• 95%



A Simple Quantitative Example

Example 14

Assume you have a financial asset with the following details:

- \$ 10 million in HSBC shares
- Volatility is 2% per day and 32% per year

Find 10-day VaR at 99% confidence level

- The standard deviation of daily changes in the value of the asset is:
2% of \$ 10 million = \$ 200,000
- Assuming the changes on successive days are independent, the standard deviation over 10-day period to be
 $\$ 200,000 \times \sqrt{10} = \$ 632,456$
- 99% confidence level implies $N(-2.33) = 0.01$
- Thus, 10-day 99% VaR for that \$10 million portfolio is:
 $\$632,456 \times 2.33 = \$ 1,473,621$

Modified from *Options, Futures, & Other Derivatives*,
by John C. Hull, 4th Edition, Prentice Hall, 2000

IAS 32, IAS 39, IFRS 4 and IFRS 7

(Afternoon Session)

21 July 2007

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