IAS 32, IAS 39, IFRS 4 and IFRS 7

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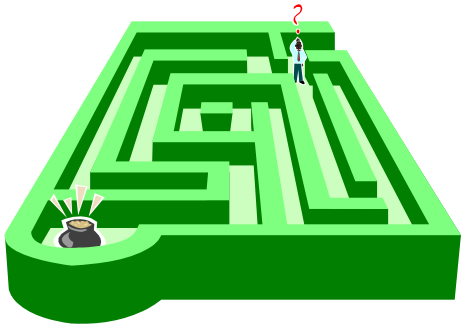
Nelson Lam 林智遠
MBA MSc BBA ACA CFA CPA(Aust)
CPA(US) FCCA FCPA(Practising) MSCA

IAS 32, IAS 39, IFRS 4 and IFRS 7

Anyone who says they understand IAS 39 has not read it ……

Professor Sir David Tweedie
Chairman of IASB



IAS 32, IAS 39, IFRS 4 and IFRS 7

IAS 32 ⇒ Financial Instruments: Presentation

IAS 39 ⇒ Financial Instruments: Recognition and measurement

IFRS 7 ⇒ Financial Instruments: Disclosure

- The most interesting standards
- The most lengthiest standards
- The most complex standards
- Cover some unusual or more complex contracts
- But also cover some very simple elements in the financial statements, for example:
  - Cash, trade receivable ……
  - Share capital, trade payable, bank loans ……

IFRS 4 ⇒ Insurance Contracts

Main Coverage

IAS 32

- Presentation
  - Liabilities and Equity
  - Compound Financial Instruments
  - Offsetting
- Disclosure requirements

IFRS 7

- Disclosure requirements

IFRS 4

- Limited improvements
- Disclosure requirements

IAS 39

- Classification of financial instruments
- Recognition and derecognition of financial instruments
- Measurement of financial instruments
- Derivatives and embedded derivatives
- Hedging and hedge accounting

Implication?

Implication of IAS 39 and IFRS 4

Case

China Life Insurance Company Limited

- Accounting report 2005 (1st year in adopting HKAS 39 & HKFRS 4)
  - The adoption of HKAS 39 resulted in
    - a change in the accounting policy relating to the classification of financial assets at fair value through income and available-for-sale securities.
    - but no change in equity at 1 January 2005 ……
  - The adoption of HKFRS 4 has resulted in
    - a change in the classification of insurance contracts and investment contracts.
  - HKFRS 4 applies to
    - i) all direct and assumed risk insurance contracts ("insurance contracts") and
    - ii) all investment contracts with a discretionary participation feature ("investment contracts with DPF") of the Group.
  - All other contracts ("investment contracts without DPF") of the Group fall into the scope of HKAS 39 ……

Implication of IAS 39 and IFRS 4

Case

China Life Insurance Company Limited

- Accounting report 2005 (1st year in adopting HKAS 39 & HKFRS 4)
  - The Group issues contracts that transfer insurance risk or financial risk or both.
    - Insurance contracts are those contracts that transfer significant insurance risk. They may also transfer financial risk.
    - Investment contracts are those contracts that transfer financial risk with no significant insurance risk.
    - A number of insurance and investment contracts contain a DPF (Discretionary Participation Feature). This feature entitles the holder to receive, as a supplement to benefits under the contracts, additional benefits or bonuses that are, at least in part, discretionary to the Group.
  - Insurance contracts and investment contracts with DPF are classified into three main categories.
    - i) Short-term insurance contracts ……
    - ii) Long-term traditional insurance contracts ……
    - iii) Long-term investment type insurance contracts and investment contracts with DPF.

Implication of IAS 39 and IFRS 4

Case

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 ……

Implication?

Today's Agenda

Morning Session

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

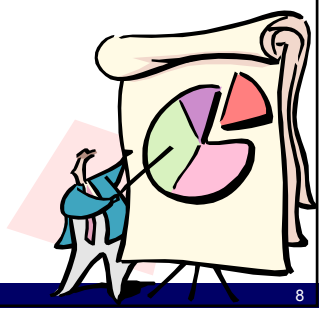
Afternoon Session

- 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



Today's Agenda – Morning

Morning Session

- Financial Instruments

Scope	• Extended the scope to all contract to buy and sell of non-financial items that meet the scope.
Definitions	• Financial instruments, including derivatives, are clearly defined.
Initial Recognition	• All financial instruments, including derivatives, are recognised in the balance sheet (on balance sheet).
Measurement	• Except for strict conditions are fulfilled, all financial assets are measured at fair value
Derivatives	• More explanation on derivatives and backdrop of hedging

Today's Agenda – Morning

Morning Session

Scope

Scope – Excluded from IAS 32 and 39

IFRS 7

	IAS 32	IAS 39
Interests in subsidiaries, associates and joint ventures accounted for under IAS 27, 28 and 31	×	×
Rights and obligations under leases to which IAS 17 applies except for derecognition and embedded derivatives		×
Employers' rights and obligations under employee benefit plans, to which IAS 19 applies	×	×
Financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32		×
Rights and obligations under an insurance contract as defined in IFRS 4, except for embedded derivatives	×	×
Contracts for contingent consideration in a business combination (see IFRS 3) for the acquirer only	×	×
Contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date		×
Certain loan commitments (IAS 37 and 18)		×
Instruments and obligations under share-based payment transactions (IFRS 2), except for some contracts	×	×
Rights to payment to reimburse a recognised provision under IAS 37		×

Scope – Excluded from IAS 32 and 39

Example

1. Tony buys a 6-month future contract in oil with a bank over the counter and Tony uses it to hedge with the oil that it would buy in 6 months for his factory.

2. Tony also signs a contract to buy oil from a US oil company and the oil company promises to deliver the oil in 3 months.

Are these two contracts within the scope of IAS 39?

Scope – Excluded from IAS 32 and 39

Contracts to buy or sell a non-financial item can be divided into 2 types:

1. that can be settled
   - net in cash or another financial instrument, or
   - by exchanging financial instruments

Forward contracts
- as if financial instruments
- within scope

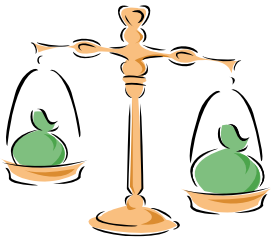
2. that were entered into and continue to be held
   - for the purpose of the receipt or delivery of a non-financial item
   - in accordance with the entity's expected purchase, sale or usage requirements

Usual executory contracts
- **NOT** within scope

Today's Agenda – Morning

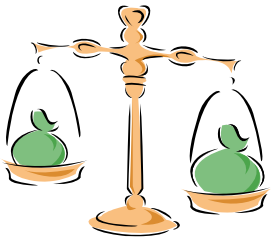
Morning Session

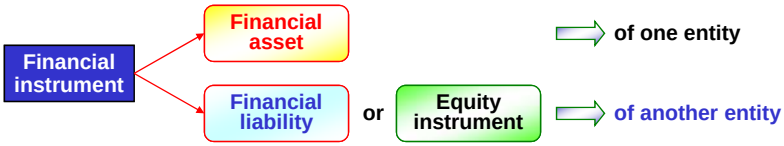
Definitions



Definitions and Classification

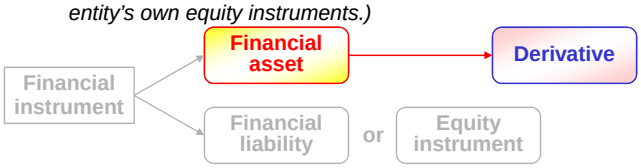
A **financial instrument** is any contract that gives rise to
1. a **financial asset** of one entity, and
2. a **financial liability** or **equity instrument** of another equity





Definitions – Financial Instruments

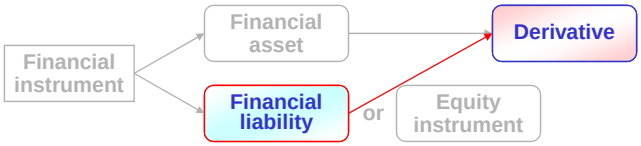
Financial asset is any asset that is:
- Cash
- An equity instrument of another entity
- A contractual right
  - i) to receive cash or another financial asset from another entity
  - ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity
- A contract that will or may settled in the entity's own equity instruments and is
  - i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. *(For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.)*



Definitions – Financial Instruments

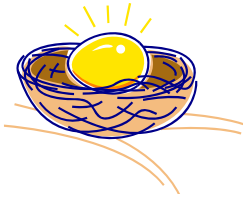
Financial liability is any liability that is

- A contractual right
  - i) to deliver cash or another financial asset from another entity
  - ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity
- A contract that will or may settled in the entity's own equity instruments and is
  - i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. *(For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.)*



Definitions – Financial Instruments

Equity instruments ⇒ is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities



Definitions – Financial Instruments

Example

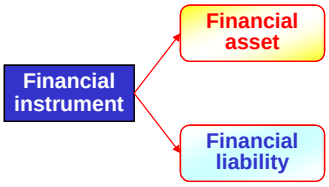
Gold Bullion

- Is gold bullion a financial instrument (like cash) or is it a commodity?

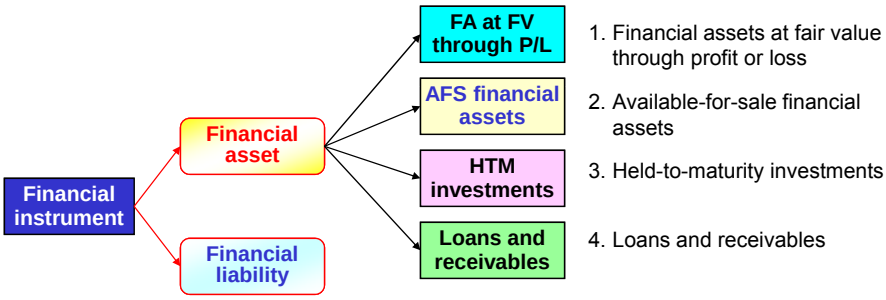
It is a commodity.

- Bullion is highly liquid
- But there is no contractual right to receive cash or another financial asset inherent in bullion.

Definitions and Classification



Definitions and Classification



- Initial recognition and measurement principle for financial assets and financial liabilities are the same (to be discussed later)
- But, IAS 39 further defines financial asset into 4 categories for subsequent measurement (financial liability to be discussed later)

The 4-category classification will affect the subsequent measurement of financial assets, but not the initial measurement.

Definitions and Classification

FA at FV through P/L

Definition – for Financial Assets at Fair Value through P/L

A financial asset that meets either of the following 2 conditions.

a) It is classified as **held for trading**, if it is:
   i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
   ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
   iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

An entity has NO choice

b) Upon **initial recognition** it is **designated** by the entity as at fair value through profit or loss (only if the entity meets any one of the conditions in IAS 39)

If an entity meets the condition, it has a choice (since 2006)

Definitions and Classification

FA at FV through P/L

Definition – for Financial Assets at Fair Value through P/L

Effective from 1.1.2006: Upon initial recognition, an entity may designate a financial asset or financial liability as at fair value through profit or loss only:

- when permitted by paragraph 11A of IAS 39 (in order to avoid separation of embedded derivative from hybrid contract), or
- when doing so results in more relevant information, because either
  - i) it eliminates or significantly reduces a measurement or recognition inconsistency
  - ii) financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis

1. Embedded Derivative Condition

2. Eliminates Inconsistency

3. Managed on Fair Value Basis

3 Conditions to Designate

Definitions and Classification

Case

中国建设银行
China Construction Bank

Fair Value Through Profit and Loss (Annual Report 2006)

- Financial assets and financial liabilities are designated at fair value through profit or loss upon initial recognition when:
  - the financial assets or financial liabilities are managed, evaluated and reported internally on a fair value basis;
  - the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise;
  - the financial asset or financial liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract; or
  - the separation of the embedded derivatives from the financial instrument is prohibited.
- All derivatives not qualified for hedging purposes are included in this category and are carried as assets when their fair value is positive and as liabilities when their fair value is negative.

Definitions and Classification

FA at FV through P/L | **AFS financial assets**

Definition – for Available-for-sale financial assets

- Those non-derivative financial assets that are designated as available for sale, or
- Those not classified into other categories

An entity has a choice

- Implies
  - ⇒ Except for those held for trading, all the remaining financial assets can be designated as AFS financial assets
  - ⇒ Loans and receivables and HTM investments can also be initially designated as AFS financial assets

Definitions and Classification

FA at FV through P/L | AFS financial assets | **HTM investments**

Definition
for Held-to-Maturity Investments

- Non-derivative financial assets with fixed or determinable payments and fixed maturity
- That the entity has the positive intention and ability to hold to maturity, other than
  - those initially designated as FA at FV through P/L
  - those designated as AFS financial assets
  - those that meet the definition of loans and receivables

- A debt instrument with a variable interest rate can satisfy the criteria for a HTM investment.
- Equity instruments cannot be HTM investments either
  - because they have an indefinite life (such as ordinary shares) or
  - because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights).

Definitions and Classification

Example

HTM investments

Definition
for Held-to-Maturity Investments

ABC Co. buys the following listed notes and intends to hold them to maturity:

- 5% 5-Year note ⇒ √ HTM investments
- HIBOR 3-Year bank note ⇒ √ HTM investments
- 10% 1-year equity-linked note ⇒ √ but the put option element shall be separated and accounted for as Embedded Derivative (to be discussed)
  (at maturity, ABC co. can receive either principal with interest or HSBC shares if the price of HSBC shares falls below $135 each)

Definitions and Classification

Subject to Tainting Rule below

HTM investments

Definition
for Held-to-Maturity Investments

An entity shall not classify any financial assets as held to maturity
- if the entity has,
  - during the current financial year or
  - during the two preceding financial years,
  - sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity
    (more than insignificant in relation to the total amount of held-to-maturity investments)

The sales or reclassifications are exempted from the above Tainting Rule if they:
- are so close to maturity or the financial asset's call date (for example, less than 3 months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
- occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or
- are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

Definitions and Classification

Example

Subject to **Tainting Rule** below

HTM investments

Definition

for Held-to-Maturity Investments

Sale of HTM investments

- Entity A sells $1,000 bonds from its HTM portfolio with $5,000 bonds on interim date of 2003 before the bonds will be matured in 2007.
- Since Entity A wants to realise the appreciation in market price of the bonds.

- The disposed bonds would be over an insignificant amount of the whole portfolio and it is not an exemption from Tainting Rule.
- The sale of part of the HTM portfolio "taints" that the entire portfolio and all remaining investments in the HTM category must be reclassified.
- Entity A will be prohibited from classifying any assets as HTM investments for 2 full financial years, until the year of 2006.

Definitions and Classification

Example

Subject to **Tainting Rule** below

HTM investments

Definition

for Held-to-Maturity Investments

Different categories of HTM Investments

Can an entity apply the **Tainting Rule** for held-to-maturity classification separately to different categories of HTM investments, such as

- debt instruments denominated in US dollars and
- debt instruments denominated in Euro?

No.

- The **Tainting Rule** is clear
  - if an entity has sold or reclassified more than an insignificant amount of HTM investments, it cannot classify any financial assets as HTM investments.

Definitions and Classification

Example

Subject to **Tainting Rule** below

HTM investments

Definition
for Held-to-Maturity Investments

Different entities in a group

Can an entity apply the **Tainting Rule** separately to HTM investments held by different entities in a consolidated group, for example, if those group entities are in different countries with different legal or economic environments?

No.

- If an entity has sold or reclassified more than an insignificant amount of investments classified as held-to-maturity in the consolidated financial statements, it cannot classify any financial assets as HTM investments in the consolidated financial statements unless the exemption conditions in IAS 39 are met.

Definitions and Classification

Case

Hang Seng Bank *(2004 Annual Report)*

- On 1 January 2005, the Group has *reclassified most* of its Held-to-Maturity debt securities as Available-for-Sale securities.
- The change in fair value will cause *volatility* to the shareholders' equity.
- On transition, the revaluation gain or loss will be adjusted through a reserve in the shareholder's equity.
- No restatement of the 2004 accounts is required.

Explained why!

Why volatility to equity?
to be discussed later

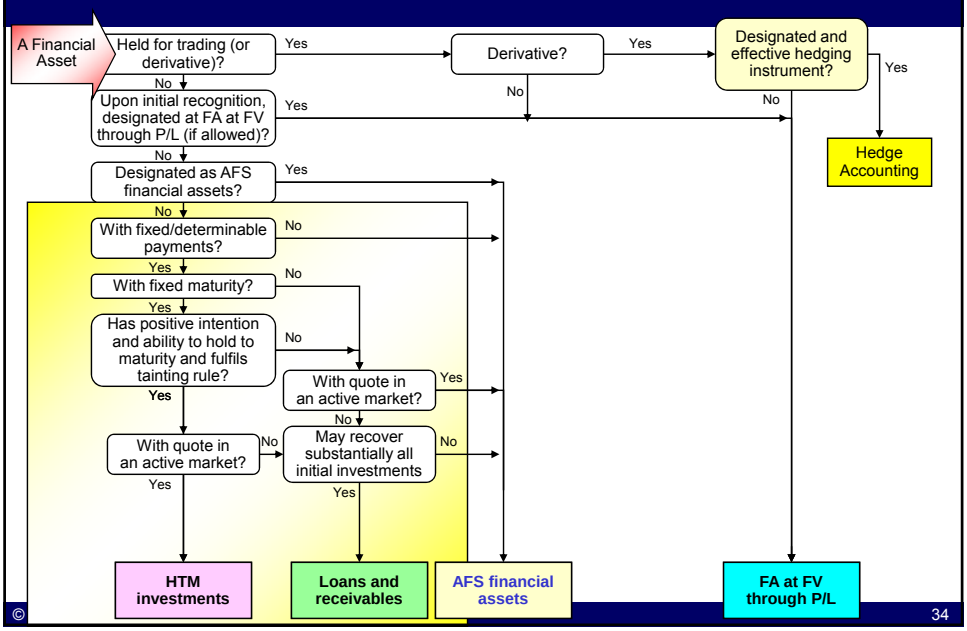
恒生銀行
HANG SENG BANK

Definitions and Classification

FA at FV through P/L | AFS financial assets | HTM investments | **Loans and receivables** | Definition

- Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than
  - those the entity intends to sell immediately or in the near term (which shall be classified as held for trading)
  - those initially designated as FA at FV through P/L
  - those initially designated as AFS financial assets
  - those for which the holder may not recover substantially all of its the initial investment, other than because of credit deterioration, which shall be classified as AFS financial assets
- An interest acquired in a pool of assets that are not loans or receivables is not a loan or receivable (for example, an interest in a mutual fund or a similar fund).
- Examples include: loan assets, trade receivables, rental deposits, deposits held by banks ……

Definitions and Classification



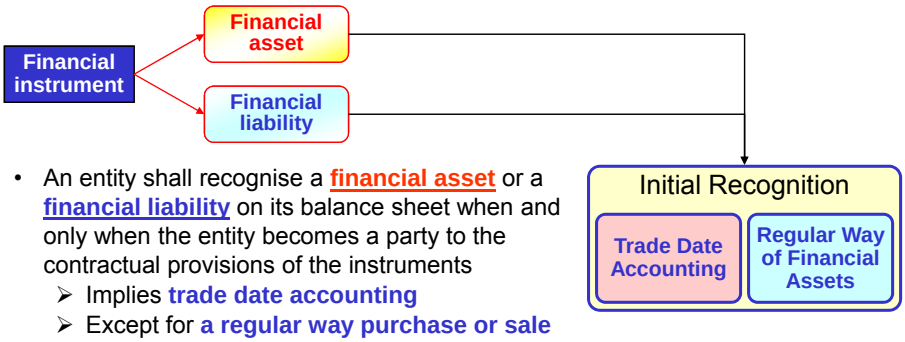
Today's Agenda – Morning

Morning Session

Initial Recognition

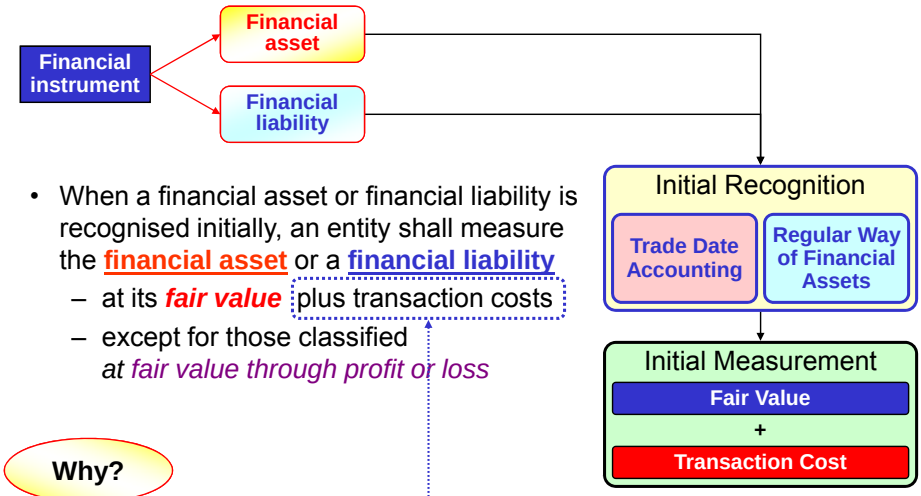
Measurement

Initial Recognition & Measurement



- An entity shall recognise a **financial asset** or a **financial liability** on its balance sheet when and only when the entity becomes a party to the contractual provisions of the instruments
  - Implies **trade date accounting**
  - Except for **a regular way purchase or sale of financial assets** (to be discussed)
- As a consequence of this principle, an entity recognise all of its contractual rights and obligations under derivatives in its balance sheet as assets and liabilities respectively.
- Examples:
  - Committing to a purchase of equity securities
  - Committing to write a derivative option

Initial Recognition & Measurement



- When a financial asset or financial liability is recognised initially, an entity shall measure the **financial asset** or a **financial liability**
  - at its ***fair value*** plus transaction costs
  - except for those classified *at fair value through profit or loss*

Why?

No transaction cost will be initially recognised for financial instruments ***at fair value through profit or loss***

Initial Recognition & Measurement

- **A regular way purchase or sale** is a purchase or sale of a **financial asset** under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.
- A regular way purchase or sale of financial assets shall be recognised (and derecognised) using either
  - **trade date accounting**, or
  - **settlement date accounting**
- The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets

- A contract that requires or permits net settlement of the change in the value of the contract is NOT a regular way contract.
- Instead, such a contract is accounted for as
  - **a derivative in the period between the trade date and the settlement date**

Initial Recognition & Measurement

Example

Fair value at Initial Recognition – Low Interest Loan

- Entity A grants a 3-year loan of $50,000 to a unrelated party, B, on 1 Jan. 2005.
  - A charges B at an interest rate of 2% as A looks for further business with B.
  - A normally charges other parties at a current market lending rate of 4%.
- Discuss the implication of the loan.

Fair value at Initial Recognition – No Interest Deposit

- Entity X is required to deposit $50,000 to a customer in order to guarantee that it would complete the service contract in 5 years' time.
- When the contract completes (say after 5 years), the deposit would be refunded in full without any interest.

Initial Recognition & Measurement

Initial Measurement (IAS 39.AG64)

- The fair value of a financial instrument on initial recognition is normally the **transaction price** (i.e. the fair value of the consideration given or received).
- However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique.
  - For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as
    - the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating.
  - Any additional amount lent is an expense or a reduction of income
    - unless it qualifies for recognition as some other type of asset.

Initial Recognition & Measurement

Case

CIIH 中保國際控股有限公司 China Insurance International Holdings Company Limited

- Accounting report 2006

Investments in debt and equity securities

– The group's and the company's policies for investments in debt and equity securities, other than investments in subsidiaries, associates and jointly controlled entities, are as follows:
  - o Investments in debt and equity securities are initially stated at cost, which is their transaction price
    - unless fair value can be more reliably estimated using valuation techniques whose variables include only data from observable markets.
  - o Cost includes attributable transaction costs, except where indicated ……

– These investments are subsequently accounted for as follows, depending on their classification:
  - i) Securities designated at fair value through profit or loss ……
  - ii) Held-to-maturity securities ……
  - iii) Available-for-sale securities ……

Initial Recognition & Measurement

Example

Fair value at Initial Recognition – Low Interest Loan

- Entity A grants a 3-year loan of $50,000 to a related party, B, on 1 Jan. 2005 as one kind of financial assistance to support B's operation.
  - A charges B at a interest rate of 4% as A expects the return on B's future operation would be higher.
  - A charges another related party at a current market lending rate of 6%
- Discuss the implication of the loan.

- On initial recognition, Entity A should recognise the carrying amount of the loan at the fair value of the payments that it will receive from the related party.
- How is the fair value of the payments at initial recognition calculated?

Initial Recognition & Measurement

Example

	Cash inflow	Discount factor	Present value
31.12.2005	$ 50,000 x 4% = $ 2,000	1 / (1 + 6%)^1	$ 1,887
31.12.2006	$ 2,000	1 / (1 + 6%)^2	$ 1,780
31.12.2007	$ 52,000	1 / (1 + 6%)^3	$ 43,660
	Fair value at initial recognition		*$ 47,327*

- Discounting the interest and principal repayments using the market rate of 6%, Entity A will recognise an originated loan of $47,327.
- The difference of $ 2,673 is expensed immediately
  - as the expectation about future operating profit of Entity B does not qualify for recognition as an intangible asset.

Initial Recognition & Measurement

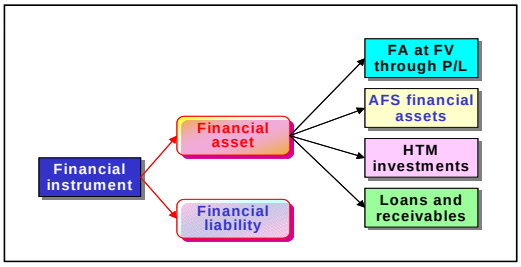
No Active Market: Valuation Technique (IAS 39.AG79)

- Short-term receivables and payables with no stated interest rate may be measured
  - at the original invoice amount if the effect of discounting is immaterial.

- Implies, no matter it is receivable from related party, or interest-free
  - No discounting may be required
  - Effective interest estimates (imputed interest) may be required
- Can management argue it is "repayable on demand", even they expect that it would not be repaid soon?
  - Is it an estimate or judgement issue?

Today's Agenda – Morning

Morning Session



Measurement

- **Financial Assets – Subsequent Measurement**

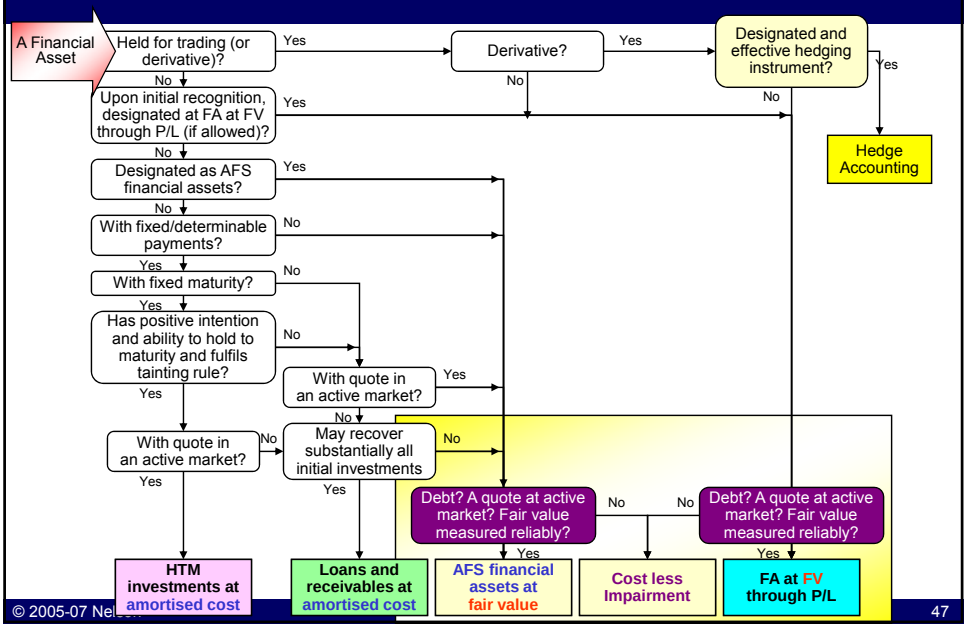
Measurement after Recognition

Classification determine Subsequent Measurement

FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value / at Cost
HTM investments	at Amortised Cost
Loans and receivables	at Amortised Cost

Except for
- investments in equity instruments that
  - do not have a quoted market price in an active market, and
  - whose fair value cannot be reliably measured

Measurement after Recognition



Measurement after Recognition

Subsequent Measurement

FA at FV through P/L	**at Fair Value** ⇨	**Gain or loss** shall be recognised **in profit or loss**
AFS financial assets	**at Fair Value** ⇨	**Gain or loss** recognised directly **in equity**
	at Cost	
HTM investments	**at Amortised Cost**	
Loans and receivables	**at Amortised Cost**	

- Except for
  - Impairment losses and
  - Foreign exchange gains and losses (financial asset is treated as if it were carried at amortised cost in the foreign currency for translation purpose)
- Cumulative gain or loss recognised directly in equity shall be transferred to profit or loss on derecognition of the financial asset

Measurement after Recognition

- **Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Active market exists

- A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange and similar entities.
- The existence of published price quotations in an active market is the best evidence of fair value and when they exist they should be used to measure the financial asset (or financial liability)
  - For an asset held (or liability to be issued) → Current bid price
  - For an asset to be acquired (liability held) → Current ask price
  - If the current bid and asking prices not available → Price of most recent transaction

Measurement after Recognition

- **Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

No active market

- An entity establishes fair value by using a valuation technique
- To establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations
- Valuation techniques include
  - Using recent arm's length market transactions between knowledgeable, willing parties
  - Discounted cash flow analysis
  - Option pricing models

- Can NAV of an unlisted entity be considered as fair value?
- It is much like a finance question …… yes & no

Measurement after Recognition

Case

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

- Accounting report 2006

  Fair value of financial instruments

  - For financial instruments where there is not an active market, the fair value is determined by using valuation techniques. Such techniques include
    - using recent arm's length transactions,
    - reference to the current market value of another instrument which is substantially the same,
    - discounted cash flow analysis and/or
    - option pricing models ……
  - The use of different pricing models and assumptions could produce materially different estimates of fair values.

Measurement after Recognition

Subsequent Measurement

FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value at Cost
HTM investments	at Amortised Cost
Loans and receivables	at Amortised Cost

Amortised cost of a financial instrument is:

- the amount at which the financial instrument is measured at initial recognition
- minus principal repayments,
- plus or minus the cumulative amortisation using **the effective interest method** of any difference between that initial amount and the maturity amount, and
- minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

Measurement after Recognition

Case

CIIH 中保國際控股有限公司 China Insurance International Holdings Company Limited

- Accounting report 2006

Insurance debtors, other debtors and amounts due from group companies

– Insurance debtors, other debtors and amounts due from group companies are initially recognised at fair value and thereafter stated at amortised cost less impairment losses for bad and doubtful debts,
  - o except where the receivables are interest-free loans made to related parties without any fixed repayment terms or the effect of discounting would be immaterial.
    - In such cases, the receivables are stated at cost less impairment losses for bad and doubtful.

Measurement after Recognition

- The effective interest method is a method
  - of calculating the amortised cost of a financial instruments (or group of financial instruments) and
  - of allocating the interest income/expense over the relevant period.
- The effective interest rate is the rate
  - is the rate that exactly discounts estimated future cash payments/receipts through the expected life of the financial instrument or,
  - when appropriate, a shorter period to the net carrying amount of the financial instrument.
- When calculating the effective interest rate,
  - an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses.

Measurement after Recognition

- The calculation includes
  - all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18),
  - transaction costs, and
  - all other premiums or discounts.
- There is a presumption that
  - the cash flows and the expected life of a group of similar financial instruments can be estimated reliably.
- When applying the effective interest method
  - an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument.

Measurement after Recognition

Case

Hang Seng Bank *(2004 Annual Report)*

Loan fee income and costs

- The current policy for
  - recognition of loan fee income and servicing cost
    - is set out in note 3(a) above and
  - incentive or rebate on loan origination
    - is charged as interest expense as incurred or amortised over the contractual loan life.
- On adoption of HKAS 39,
  - substantially all loan fee income and directly attributable loan origination costs (including mortgage incentive payments) will be
    - amortised over the expected life of the loan as part of the effective interest calculation.

恒生銀行 HANG SENG BANK

Measurement after Recognition

Example

Amortised Cost on Low Interest Loan

- Followed on the previous example, Entity A grants a 3-year loan of $50,000 to an important new customer in 1 Jan. 2005
  - The interest rate on the loan is 4%
  - The current market lending rates for similar loans is 6%
- Entity A believes that the future business to be generated with this new customer will lead to a profitable lending relationship.
- On initial recognition, Entity A recognised $47,327 (as calculated below):

	Cash inflow	Discount factor	Present value
31.12.2005	$ 50,000 x 4% = $ 2,000	$1 / (1 + 6\%)^1$	$ 1,887
31.12.2006	$ 2,000	$1 / (1 + 6\%)^2$	$ 1,780
31.12.2007	$ 52,000	$1 / (1 + 6\%)^3$	$ 43,660
		Fair value at initial recognition	*$ 47,327*

- Calculate the amortised cost each year end.

Measurement after Recognition

Example

	Balance b/f	Effective interest (6%)	Interest received (4%)	Balance c/f
31.12.2005	$ 47,327	$ 2,840	($ 2,000)	$ 48,167
31.12.2006	$ 48,167	$ 2,890	($ 2,000)	$ 49,057
31.12.2007	$ 49,057	$ 2,943	($ 2,000)	$ 50,000

- For example, at 31.12.2005, the entry is:

Dr	Loans receivable ($47,327 x 6%)	2,840	
Cr	Interest income (P/L)		2,840
	Being effective interest income recognised for the year.		
Dr	Cash (interest received, $50,000 x 4%)	2,000	
Cr	Loans receivable		2,000
	Being cash interest received.		

Measurement – Impairment

	Subsequent Measurement
FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value at Cost
HTM investments	at Amortised Cost
Loans and receivables	at Amortised Cost

Impairment

At each balance sheet date

- assess whether there is any objective evidence that a financial asset (or group of financial assets) is impaired.
- Conditions must be fulfilled in recognising impairment loss ……

Measurement – Impairment

Outside the scope of IAS 36

Conditions for Impairment

- A financial asset (or a group of financial assets) is impaired and impairment losses are incurred if, and only if
  - there is objective evidence of impairment as a result of one or more events
    - that occurred after the initial recognition of the asset (a '**loss event**') and
    - that loss event (or events) has **an impact on the estimated future cash flows** of the financial asset (or group of financial assets that) can be reliably estimated.
- It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment.
- Losses expected as a result of future events, no matter how likely, are not recognised.

Measurement – Impairment

Outside the scope of IAS 36

Impairment (if there is objective evidence)

FA at FV through P/L	**at Fair Value** ➡	Implicitly, no impairment review is needed as gain or loss on change in fair value is recognised in profit or loss
AFS financial assets		
HTM investments		
Loans and receivables		

Measurement – Impairment

Outside the scope of IAS 36

Impairment (if there is objective evidence)

FA at FV through P/L	at Fair Value	
AFS financial assets	at Fair Value at Cost	
HTM investments	**at Amortised Cost** ➡	
Loans and receivables	**at Amortised Cost** ➡	

- The amount of impairment loss is measured as the difference between
  - the asset's carrying amount and
  - the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition)
- The carrying amount of the asset shall be reduced either
  - directly or
  - through use of an allowance account.
- The amount of the loss shall be recognised in profit or loss.

Measurement – Impairment

Outside the scope of IAS 36

Impairment (if there is objective evidence)

FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value at Cost
HTM investments	**at Amortised Cost** ➡
Loans and receivables	**at Amortised Cost** ➡

Sequence of Impairment Assessment

- First assesses whether objective evidence of impairment exists
  - individually for financial assets that are individually significant, and
  - individually or collectively for financial assets that are not individually significant.
- If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not
  - it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment.
- Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

Measurement – Impairment

Example

Amortised Cost on Low Interest Loan

- Followed on previous example, Entity A grants a 3-year loan of $50,000 to an important new customer in 1 Jan. 2005
  - The interest rate on the loan is 4%
  - The current market lending rates for similar loans is 6%
- On initial recognition, Entity A recognised $47,327 and at 31 Dec. 2005, the amortised cost was $ 48,167. The repayment schedule is:

	Balance b/f	Effective interest (6%)	Interest received (4%)	Balance c/f
31.12.2005	$ 47,327	$ 2,840	($ 2,000)	$ 48,167
31.12.2006	$ 48,167	$ 2,890	($ 2,000)	$ 49,057
31.12.2007	$ 49,057	$ 2,943	($ 2,000)	$ 50,000

- At 2 Jan. 2006, Entity A agreed a loan restructure with the customer and waived all the interest payments in 2006 and 2007.

Measurement – Impairment

Example

	Cash to be received as estimated at 2.1.2006	Discount factor	Present value
31.12.2006	$ 0	1 / (1 + 6%)[1]	$ 0
31.12.2007	$ 50,000	1 / (1 + 6%)[2]	$ 44,500

Carrying amount (per the balance as at 31.12.2006)	$ 48,167
Present Value of estimated future cash flows discounted at original effective interest rate as at 2.1.2006	44,500
Impairment loss	$ 3,667

Dr	Impairment loss (in income statement)	$3,667	
Cr	Allowance on impairment loss (alternatively, Loans and receivables)		$3,667

Measurement – Impairment

Case

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

- Accounting report 2006

Impairment of financial assets

- The Group assesses at each balance sheet date whether a financial asset or group of financial assets is impaired ……
- The Group first assesses whether objective evidence of impairment exists
  - individually for financial assets that are individually significant, and
  - individually or collectively for financial assets that are not individually significant.

Individual Assessment

- If it is determined that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not,
  - the asset is included in a group of financial assets with similar credit risk characteristics and
  - that group of financial assets is collectively assessed for impairment.

Collective Assessment

- Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognized
  - are not included in a collective assessment of impairment.
- The impairment assessment is performed at each balance sheet date.

Measurement – Impairment

Outside the scope of IAS 36

Impairment (if there is objective evidence)

FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value
	at Cost
HTM investments	
Loans and receivables	

- The amount of the impairment loss is measured as the difference between
  - the carrying amount of the financial asset and
  - the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

Measurement – Impairment

Outside the scope of IAS 36

Impairment (if there is objective evidence)

FA at FV through P/L	at Fair Value
AFS financial assets	**at Fair Value**
HTM investments	
Loans and receivables	

- 2 conditions to effect impairment loss
  - when a decline in the fair value of an AFS financial asset has been recognised directly in equity and
  - there is objective evidence that the asset is impaired
- Then, the cumulative loss that had been recognised directly in equity shall be
  - removed from equity and
  - recognised in profit or loss

  even the asset has not been derecognised.
- The amount of the cumulative loss that is removed from equity and recognised in profit or loss shall be the difference between
  - the acquisition cost (net of any principal repayment and amortisation) and
  - the current fair value
  - less any impairment loss on that financial asset previously recognised in profit or loss.

Implication?

Measurement – Impairment

Example

Impairment Based on Ageing Analysis

- Entity A calculates impairment in the unsecured portion of loans and receivables on the basis of a provision matrix
  - that specifies fixed provision rates for the number of days a loan has been classified as non-performing as follows:
    - 0% if less than 90 days
    - 20% if 90-180 days
    - 50% if 181-365 days, and
    - 100% if more than 365 days
- Can the results be considered to be appropriate for the purpose of calculating the impairment loss on loans and receivables?

Not necessarily.

- IAS 39 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial instrument's original effective interest rate.

Measurement – Impairment

Example

Aggregate Fair Value Less Than Carrying Amount

- IAS 39 requires that gains and losses arising from changes in fair value on AFS financial assets are recognised directly in equity.
- If the aggregate fair value of such assets is less than their carrying amount, should the aggregate net loss that has been recognised directly in equity be removed from equity and recognised in profit or loss?

Not necessarily.

- The relevant criterion is not whether the aggregate fair value is less than the carrying amount, but whether there is objective evidence that a financial asset or group of assets is impaired.
- An entity assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of assets may be impaired.
- IAS 39 states that a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.
- Additionally, a decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (e.g. a decline in the fair value of a bond resulting from an increase in the basic risk-free interest rate).

Measurement – Impairment

Outside the scope of IAS 36

Impairment ← **Is Reversal allowed?**

FA at FV through P/L	at Fair Value
AFS financial assets	**at Fair Value**
	at Cost
HTM investments	at Amortised Cost
Loans and receivables	at Amortised Cost

Impairment losses on **equity instrument**

- shall **NOT be reversed** through profit or loss.

Impairment losses on **debt instrument**

- If, in a subsequent period
  - the fair value of a debt instrument classified as AFS financial assets increases, and
  - the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss
- Then, the impairment loss shall be reversed, with the amount of the reversal recognised in profit or loss

Measurement – Impairment

Outside the scope of IAS 36

Impairment ← **Is Reversal allowed?**

FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value
	at Cost
HTM investments	at Amortised Cost
Loans and receivables	at Amortised Cost

Such impairment losses shall NOT be reversed

Measurement – Impairment

Outside the scope of IAS 36

Impairment ← **Is Reversal allowed?**

FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value at Cost
HTM investments	**at Amortised Cost** ←
Loans and receivables	**at Amortised Cost** ←

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

Measurement – Impairment

Case

CIIH 中保國際控股有限公司 China Insurance International Holdings Company Limited

- Accounting report 2006

Impairment of investments in debt and equity securities and other receivables

- For available-for-sale securities, the cumulative loss that has been recognised directly in equity is removed from equity and is recognised in the income statement ……
- Impairment losses recognised in the income statement in respect of available-for-sale equity securities are not reversed through the income statement.
  - Any subsequent increase in the fair value of such assets is recognised directly in equity.
- Impairment losses in respect of available-for-sale debt securities are reversed if the subsequent increase in fair value can be objectively related to an event occurring after the impairment loss was recognised.
  - Reversals of impairment losses in such circumstances are recognised in the income statement.

Measurement – Summary

	Subsequent Measurement	Impairment	Reversal	Reclassification
FA at FV through P/L	at Fair Value to P/L	Not required	N/A	Not allowed
AFS financial assets	at Fair Value to Equity at Cost	From Equity to P/L To P/L	Related objectively to an event for debt instrument only	To HTM or AFS at Cost To AFS at Fair Value
HTM investments	at Amortised Cost	To P/L	Related objectively to an event	To AFS
Loans and receivables	at Amortised Cost	To P/L	Related objectively to an event	Not described in IAS 39; implicitly, not feasible

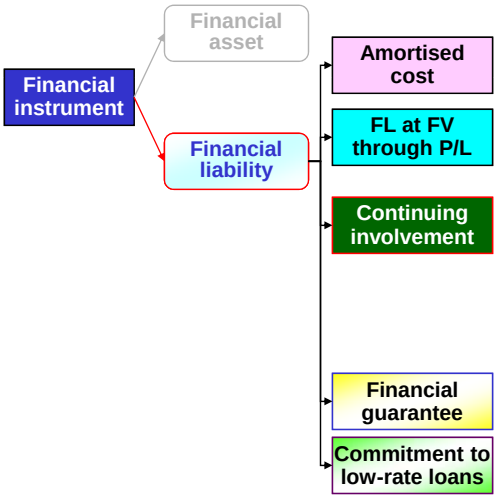
Today's Agenda – Morning

Morning Session

Measurement

- **Financial Liabilities – Subsequent Measurement**

Financial Liabilities – Measurement



After initial recognition, an entity shall measure all financial liabilities at **amortised cost** using the effective interest method, except for:

a) financial liabilities at fair value through profit or loss
b) financial liabilities that arise
   - when a transfer of a financial asset does not qualify for derecognition, or
   - when the continuing involvement approach applies.
c) Financial guarantee contracts
d) Commitments to provide a loan at a below-market interest rate.

Financial Liabilities – Measurement

Amortised cost

- Amortised cost
  - As those discussed in financial assets

FL at FV through P/L

- Financial liabilities at fair value through profit or loss
- Similar to financial asset at fair value through profit or loss
  - Those held for trading — Entity has NO choice
    - Acquired principally for selling in the near term
    - Recent actual short-term profit taking
    - Derivatives that are liabilities (except for hedging instruments)
  - Those designated (if allowed) — Entity has a choice
- Excluded those unquoted and fair value cannot be reliably measured
- If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability

Continuing involvement

- Financial liabilities that arise when
  - a transfer of a financial asset **does not qualify for derecognition**, or
  - when the **Continuing Involvement Approach** applies

Financial Liabilities – Measurement

Case

CIIH 中保國際控股有限公司 China Insurance International Holdings Company Limited

- Accounting report 2006

Insurance creditors, accrued charges and other creditors and amounts due to group companies

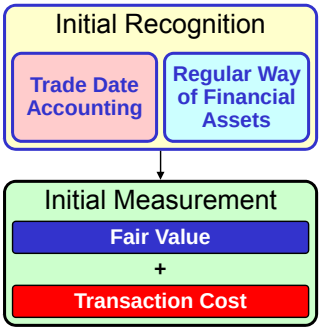
- Insurance creditors, accrued charges and other creditors and amounts due to group companies are
  - initially recognised at fair value and
  - thereafter stated at amortised cost,
    - unless the effect of discounting would be immaterial, in which case they are stated at cost.

Financial Liabilities – Measurement

Financial guarantee

Commitment to low-rate loans

- Financial guarantee contracts and commitment to provide a loan at a below-market interest rate
  - are within the scope of IAS 39.
- In consequence, the issuer shall initially recognise and measure it as other financial assets and liabilities and at
  - its fair value
  - plus transaction costs (unless classified as fair value through profit or loss)



- If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction,
  - its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

Financial Liabilities – Measurement

Financial guarantee

Commitment to low-rate loans

After initial recognition,

- An issuer of such contract and such guarantee shall measure it at the higher of:
  - i) the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and
  - ii) the amount initially recognised *less*, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

Financial Liabilities – Measurement

Financial guarantee

Asserted Explicitly

Used Insurance Accounting

- However, for financial guarantee contracts alone, such contracts may be excluded from the scope of IAS 39
- IAS 39.2e states that:

  "if an issuer of financial guarantee contracts
  - has previously asserted explicitly that it regards such contracts as insurance contracts and
  - has used accounting applicable to insurance contracts,
    - the issuer may elect to apply either
      - IAS 39 or
      - IFRS 4

      to such financial guarantee contracts (see paragraphs AG4 and AG4A).

  The issuer may make that election contract by contract, but the election for each contract is irrevocable.

Financial Liabilities – Measurement

Case

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

- Accounting report 2006

Changes in accounting policies – Financial Guarantee Contracts

- Effective January 1, 2006, the Group has adopted IAS 39 and IFRS 4 amendments on financial guarantee contracts.
  - Under the amended IAS 39, financial guarantee contracts that are not considered to be insurance contracts are
    - recognized initially at fair value and
    - generally re-measured at the higher of the amount determined in accordance with IAS 37 "Provisions, Contingent Liabilities and Contingent Assets" and the amount initially recognized less, when appropriate, cumulative amortization recognized in accordance with IAS 18 "Revenue".
- Other than any financial guarantee contracts issued by the Group's banking operations which are accounted for under IAS 39, the Group
  - has previously regarded certain contracts it issued with financial guarantee element as insurance contracts and
  - has used accounting applicable to insurance contracts,

  and accordingly has elected to apply IFRS 4 to account for such contracts.

Financial Liabilities – Measurement

Case

Annual Report 2006 – Note 3.20 clarified that

- A financial guarantee contract is
  - a contract that requires the issuer (or guarantor) to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument.
- Where the Group issues a financial guarantee, the fair value of the guarantee is initially recognised as deferred income within trade and other payables.
  - Where consideration is received or receivable for the issuance of the guarantee, the consideration is recognised in accordance with the Group's policies applicable to that category of asset.

    Dr Cash/Assets
    Cr Payables
  - Where no such consideration is received or receivable, an immediate expense is recognised in income statement on initial recognition of any deferred income.

    Dr Profit & loss
    Cr Payables

Financial Liabilities – Measurement

Case

Recruit 才庫媒體集團有限公司

Annual Report 2006 – Note 3.20 clarified that

- The amount of the guarantee initially recognised as deferred income
  - is amortised in income statement over the term of the guarantee as income from financial guarantees issued.
- In addition, provisions are recognised if and when
  - it becomes probable that the holder of the guarantee will call upon the Group under the guarantee and
  - the amount of that claim on the Group is expected to exceed the current carrying amount, i.e. the amount initially recognised less accumulated amortisation, where appropriate.

Dr Payables
Cr Profit & loss

Dr Profit & loss
Cr Payables

Financial Liabilities – Measurement

Case

Recruit 才庫媒體集團有限公司

How much did it have …….

Annual Report 2006 – Note 36 set out:

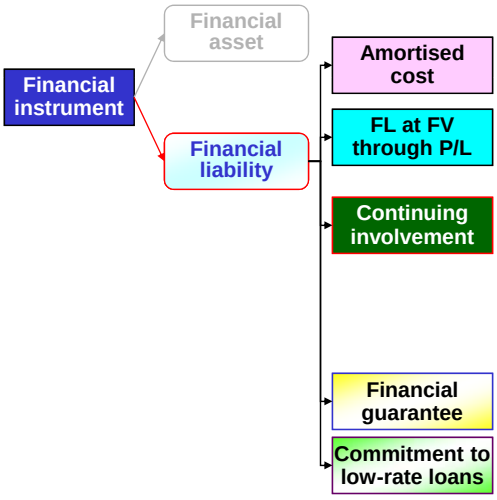
	Group		Company	
	2006	2005	2006	2005
	HK$'000	HK$'000	HK$'000	HK$'000
Corporate guarantees given and utilised*	–	–	14,000	16,000

* As at 31 December 2006, the Company has given corporate guarantees to its non wholly owned subsidiary to the extent of HK$24,700,000 (2005: HK$33,060,000) in relation to payments for certain finance leases to financial institutions as set out in Note 27 to the financial statements, HK$14,000,000 (2005: HK$16,000,000) of which was utilised.

Most critical ….. "In the opinion of the directors of the Company,

- no material liabilities will arise from the above guarantees which arose in the ordinary course of business and
- the fair value of the corporate guarantees granted by the Company is immaterial.

Financial Liabilities – Measurement



Reclassification

- Similar to financial asset, transfer into or out of financial liabilities at fair value through profit or loss is prohibited while it is held or issued
- Unless, in rare cases, a reliable measure of fair value is no longer available
- Then, it should be carried at amortised cost

Implication

- Reclassification is infrequent or rare

Today's Agenda – Morning

Morning Session

Derivatives

Definitions – Derivative

Derivative ⇒ is a financial instrument or other contract within the scope of IAS 39 with all 3 of the following characteristics:

a) its value changes in response to the change in 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 (sometimes called the 'underlying');

b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

c) it is settled at a future date.

Value change based on an underlying

Little or no initial net investment

Settled at a future date

Financial instrument → Financial asset / Financial liability or Equity instrument

Derivative

Definitions – Derivative

Example

Derivative

Typical example:

- Future and forward
- Swap and options

Value change based on an underlying

Little or no initial net investment

Settled at a future date

Type of contract	Underlying variable
Interest Rate Swap	Interest rates
Currency Swap (Foreign Exchange Swap)	Currency rates
Commodity Swap	Commodity prices
Equity Swap	Equity prices (equity of another entity)
Credit Swap	Credit rating, credit index or credit price
Total Return Swap	Total fair value of the reference asset and interest rates
Purchased or Written Treasury Bond Option	Interest rates
Purchased or Written Currency Option	Currency rates
Currency Futures/Forward	Currency rates
Commodity Futures/Forward	Commodity prices
Equity Forward	Equity prices

Definitions – Derivative

Example

Value change based on an underlying √

Little or no initial net investment √

Settled at a future date √

2 Non-Derivative Transactions

- Entity A makes a 5-year fixed rate loan to Entity B
- Entity B at the same time makes a 5-year variable rate loan for the same amount to Entity A.
- There are no transfers of principal at inception of the 2 loans, since A and B have a netting agreement
- Is this a derivative under IAS 39?

Yes, it meets the definition of a derivative.

- The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment.

Definitions – Derivative

Example

Value change based on an underlying

Little or no initial net investment

Settled at a future date

- Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative.
- Indicators of this would include:
  - They are entered into at the same time and in contemplation of one another
  - They have the same counterparty
  - They relate to the same risk
  - There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction
- The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IAS 39 does not require net settlement

Definitions – Derivative

Example

Value change based on an underlying ✓

Little or no initial net investment ✗

Settled at a future date ✓

Prepaid forward

- An entity enters into a forward contract to purchase shares of stock in 1 year at the forward price.
- It prepays at inception based on the current price of the shares.
- Is the forward contract a derivative?

No.

- The forward contract fails the "little" or no initial net investment" test for a derivative.

Derivatives – Measurement

Derivative

- What is the initial measurement and subsequent measurement on derivative?

Initial measurement

- Similar to other financial assets and liabilities
  - Fair value plus transaction cost, except for those classified at fair value through profit or loss
- But, a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument) is classified as fair value through profit or loss
  - Implies fair value only

Subsequent measurement

- As above, derivative, other than a financial guarantee contract or a designated and effective hedging instrument, is
  - classified and measured at fair value through profit or loss

Definitions – Derivative

Case

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

- Accounting report 2006

  Derivative financial instruments

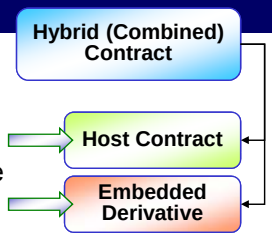
  - Derivative financial instruments include
    - options embedded in convertible bonds purchased by the Group,
    - derivatives embedded in certain insurance contracts,
    - interest rate swaps and futures,
    - credit default swaps,
    - cross currency swaps,
    - forward currency contracts, and
    - options on interest rates, currencies and equities, etc.
  - Derivative financial instruments are classified as held for trading
    - unless they are designated as effective hedging instruments.
  - All derivatives are carried
    - as assets when the fair values are positive and
    - as liabilities when the fair values are negative.

Dr	Asset
Cr	Cash
Dr	Cash
Cr	Liabilities

Embedded Derivatives

IAS 39 introduce Embedded Derivative

- it is a component of a hybrid (combined) instrument that also include a non-derivative host contract
  - with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative



- An **embedded derivative** causes some or all of the cash flows that otherwise would be required by the contract
  - to be modified according to a variable,
    - say specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable.

- A **derivative** that

  Remember what derivative is?
  - is attached to a financial instrument
  - but is contractually transferable independently of that instrument, or
  - has a different counterparty from that instrument

  is NOT an embedded derivative, BUT a separate financial instrument.

Embedded Derivatives

Example

- Investments in convertible bonds (with equity conversion feature)
- Equity-indexed interest or principal payments embedded in a host debt instrument (equity-linked interest or principal payments)
- An option or automatic provision to extend the remaining term to maturity of a debt instrument
- A call, put, surrender or prepayment option embedded in a host debt instrument
- Equity kicker
- Equity-linked notes
- Equity call and put options
- Inflation-indexed lease payments
- Contingent rentals
- More …… but so?

Host Contract

Embedded Derivative

Embedded Derivatives

Hybrid (Combined) Contract

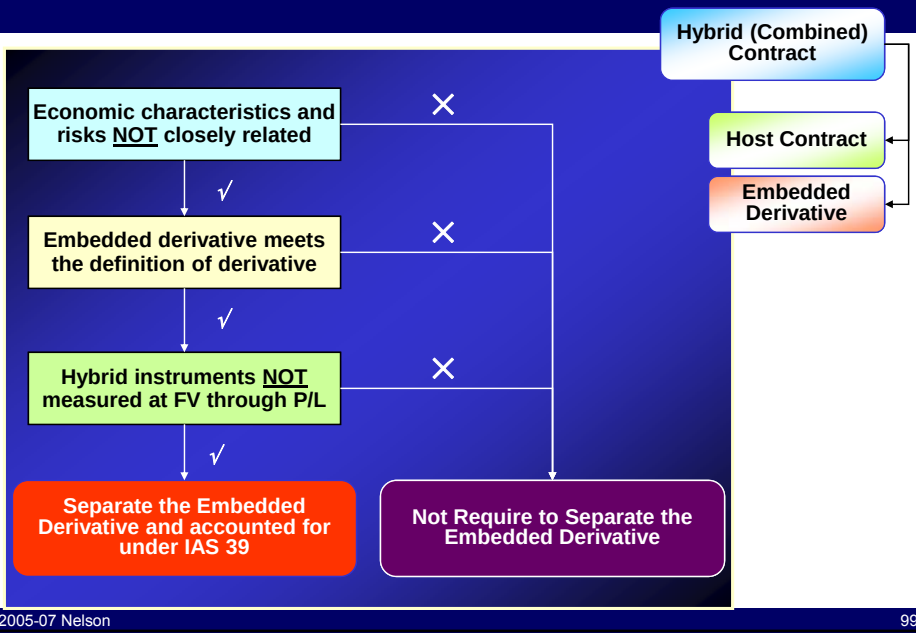
Host Contract

Embedded Derivative

IAS 39 requires an embedded derivative

- shall be separated from the host contract and
- accounted for as a derivative under IAS 39 if, and only if:
  a. the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract
  b. a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
  c. the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss

Embedded Derivatives



Embedded Derivatives

Economic characteristics and risks NOT closely related

To assess economic characteristics and risks

- If a host contract
  - has no stated or predetermined maturity and
  - represents a residual interest in the net assets of an entity
    - ➢ then its economic characteristics and risks are those of an equity instrument, and
    - ➢ an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related.
- If the host contract
  - is not an equity instrument and
  - meets the definition of a financial instrument
    - ➢ then its economic characteristics and risks are those of a debt instrument.

- Guarantee Fund?
- Alternatively, should we name it as …… bond with index-linked interest?

Embedded Derivatives

If separation is required and can be measured

⇒ Host Contract shall be accounted for under applicable IFRS

⇒ Embedded Derivative shall be accounted under IAS 39 as a derivative

If separation is required but cannot be measured

⇒ Entire Hybrid (Combined) Contract is classified as financial instrument that is held for trading

If separation is not required

⇒ Hybrid (combined) contract shall be accounted for under applicable IFRS

Separate the Embedded Derivative and accounted for under IAS 39

Not Require to Separate the Embedded Derivative

Embedded Derivatives

Example

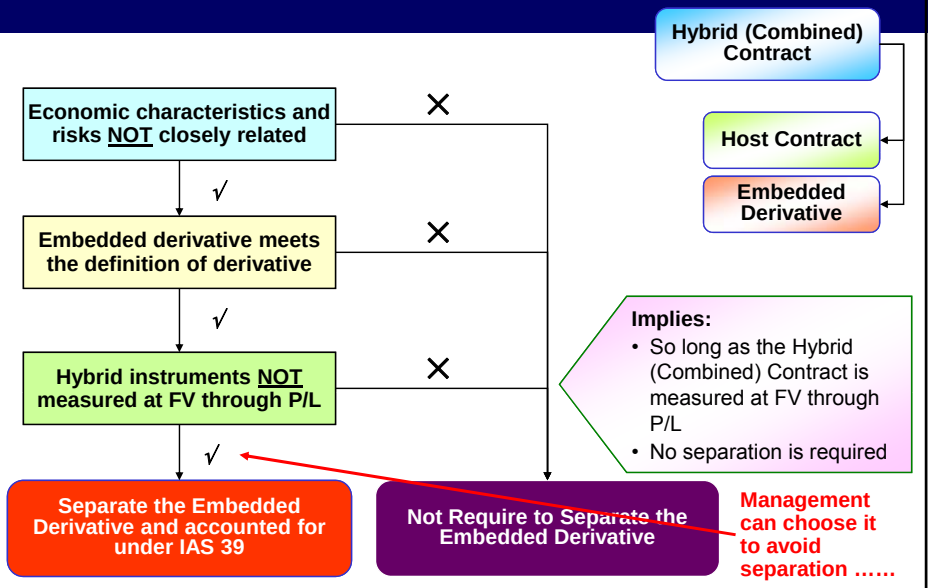
Capital protection bond, guarantee fund or bond with index-linked interest

Can a bond with a fixed payment at maturity and a fixed maturity date be classified as a held-to-maturity investment if the bond's interest payments are indexed to the price of a commodity or equity, and the entity has the positive intention and ability to hold the bond to maturity?

Yes, but ……

- The commodity-indexed or equity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value (IAS 39.11).
- IAS 39.12 (stated at fair value through profit or loss) is not applicable
  - since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

Embedded Derivatives



Embedded Derivatives

Case

HKEX *(Consolidated financial statements published on 28 Feb. 2005)*

"From 1 January 2004, investments of the Group are classified under the following categories:

Financial assets at fair value through profit or loss

This category comprises financial assets held for trading and those designated as fair value through profit or loss at inception ……

Debt securities and bank deposits with embedded derivatives for yield enhancement whose economic characteristics and risks are not closely related to the host securities and deposits are designated as financial assets at fair value through profit or loss.

Available-for-sale financial assets

This category comprises financial assets which are non-derivatives and are designated as available-for-sale financial assets or not classified under other investment categories.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, and with no intention of trading the receivables. Bank deposits are treated as loans and receivables and are disclosed as time deposits and cash equivalents."

IAS 32, IAS 39, IFRS 4 and IFRS 7

(Morning Session) 6 October 2007

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www.NelsonCPA.com.hk

Nelson Lam 林智遠
nelson@nelsoncpa.com.hk
www.nelsoncpa.com.hk

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IAS 32, IAS 39, IFRS 4 and IFRS 7

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Nelson Lam 林智遠
nelson@nelsoncpa.com.hk
www.nelsoncpa.com.hk

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