

# Update & Recap on HKFRS: Part I

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## Today's Agenda

Capital Disclosures  
(Amendment to HKAS 1)

Financial Instruments: Disclosures  
(HKFRS 7)

Recap Session

Summary of Latest Development

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# Today's Agenda

## Capital Disclosures (Amendment to HKAS 1)



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# Capital Disclosures

- We used to consider that capital is .....

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

- HKAS 1 considers
  - “whether an entity can have a view of capital that differs from what IFRSs define as equity.” (HKAS 1.BC.47)
- It further clarifies that, although for the purposes of this disclosure
  - capital would often equate with equity as defined in HKFRSs,
  - it might also include or exclude some components.
- It also noted that the capital disclosure in HKAS 1 is intended to give entities the opportunity to describe
  - how they view the components of capital they manage, if this is different from what HKFRSs define as equity .....

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## Capital Disclosures

- Based on the Framework & HKFRSs, the accounting equation should be:



- For some entities

$$\text{Capital} = \text{Equity}$$

- For some other entities

$$\text{Capital} = \text{Equity} - \text{Some Equity} + \text{Some Liabilities}$$

## Capital Disclosures

- An entity shall disclose information that enables users of its financial statements to evaluate
  - the entity's *objectives*, *policies* and *processes* for managing capital.

- To comply with the capital disclosures, the entity discloses the following:

- a) **qualitative information** about its objectives, policies and processes for managing capital, including (but not limited to):
  - i) a description of what it manages as capital;
  - ii) when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and
  - iii) how it is meeting its objectives for managing capital.

$$\text{Capital} = \text{Equity} - \text{Some Equity} + \text{Some Liabilities}$$

# Capital Disclosures

- b) summary quantitative data about what it manages as capital.  
Some entities regard some financial liabilities (e.g. some forms of subordinated debt) as part of capital.  
Other entities regard capital as excluding some components of equity (e.g. components arising from cash flow hedges).
- c) any changes in (a) and (b) from the previous period.
- d) whether during the period it complied with any externally imposed capital requirements to which it is subject.
- e) when the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.
- These disclosures shall be based on the information provided internally to the entity's key management personnel.

$$\text{Capital} = \text{Equity} - \text{Some Equity} + \text{Some Liabilities}$$

# Capital Disclosures

## Example

### Example disclosure

- The Group's objectives when managing capital are:
  - to safeguard the entity's ability to continue as a going concern,
    - so that it can continue to provide returns for shareholders and benefits for other stakeholders, and
  - to provide an adequate return to shareholders by pricing products and services commensurately with the level of risk.
- The Group sets the amount of capital in proportion to risk.

## Objectives

# Capital Disclosures

## Example

### Example disclosure

- The Group manages the capital structure and makes adjustments to it in the light of
  - changes in economic conditions and
  - the risk characteristics of the underlying assets.
- In order to maintain or adjust the capital structure, the Group may
  - adjust the amount of dividends paid to shareholders,
  - return capital to shareholders,
  - issue new shares, or
  - sell assets to reduce debt.

How



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# Capital Disclosures

## Example

### Example disclosure

- Consistently with others in the industry, the Group monitors capital on the basis of
  - the debt-to-adjusted capital ratio.
- This ratio is calculated as net debt ÷ adjusted capital.

How

#### Net debt

- is calculated as
  - Total debt (as shown in the balance sheet)
  - Less: cash & cash equivalents

#### Adjusted capital

- comprises all components of equity (i.e. share capital, share premium, minority interest, retained earnings, and revaluation reserve)
  - other than amounts recognised in equity relating to cash flow hedges, and
- includes some forms of subordinated debt.

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# Capital Disclosures

## Example

### Example disclosure (continued from previous example)

- During 20X4, the Group's strategy, which was unchanged from 20X3, was to maintain the debt-to-adjusted capital ratio at the lower end of the range 6:1 to 7:1, in order to secure access to finance at a reasonable cost by maintaining a BB credit rating. The debt-to-adjusted capital ratios at 31 December 20X4 and at 31 December 20X3 were as follows:

	31.12.X4 (\$'M)	31.12.X3 (\$'M)
Total debt	1,000	1,100
Less: cash and cash equivalents	<u>(90)</u>	<u>(150)</u>
<b>Net debt</b>	<b><u>910</u></b>	<b><u>950</u></b>
Total equity	110	105
Add: subordinated debt instruments	38	38
Less: amounts recognised in equity relating to cash flow hedges	<u>(10)</u>	<u>(5)</u>
<b>Adjusted capital</b>	<b><u>138</u></b>	<b><u>138</u></b>
<b>Debt-to-adjusted capital ratio</b>	<b>6.6</b>	<b>6.9</b>

# Capital Disclosures

## Example

### Example disclosure

- Entity A filed its quarterly regulatory capital return for 30 September 20X7 on 20 October 20X7.
- At that date, Entity A's regulatory capital was below the capital requirement imposed by Regulator B by \$1 million.
- As a result, Entity A was required to submit a plan to the regulator indicating how it would increase its regulatory capital to the amount required.
- Entity A submitted a plan that entailed selling part of its unquoted equities portfolio with a carrying amount of \$11.5 million in the fourth quarter of 20X7.
- In the fourth quarter of 20X7, Entity A sold its fixed interest investment portfolio for \$12.6 million and met its regulatory capital requirement.

For example, SFC or banks

# Capital Disclosures

## Case

- Early adopted capital disclosure in 2005 and its 2006 annual report states that (extract only):
  - The Group's objectives when managing capital are:
    - To safeguard the Group's ability to continue as a going concern, so that it continues to provide returns for shareholders and benefits for other stakeholders;
    - To support the Group's stability and growth; and
    - To provide capital for the purpose of strengthening the Group's risk management capability.
  - The Group actively and regularly reviews and manages its capital structure to ensure optimal capital structure and shareholder returns,
    - taking into consideration the future capital requirements of the Group and capital efficiency, prevailing and projected profitability, projected operating cash flows, projected capital expenditures and projected strategic investment opportunities.



# Capital Disclosures

## Case

- Early adopted capital disclosure in 2005 and its 2006 annual report states that (extract only):
  - The Group adopts a dividend policy of providing shareholders
    - with regular dividends with a target payout ratio of 90 per cent of the profit of the year,
    - while retaining 10 per cent of the profit as capital of the Group for future use.
  - As at 31 December 2006, the Group had set aside \$3,100 million of shareholders' funds (2005: \$1,500 million of retained earnings)
    - for the purpose of strengthening the risk management regime of the clearing houses and supporting their roles as central counterparties



# Capital Disclosures

## Case

- Early adopted capital disclosure in 2005 and its 2006 annual report states that (extract only):
  - As in prior years, the Group monitors capital by reviewing the level of capital that is at the disposal of the Group (“adjusted capital”).
  - Adjusted capital comprises all components of shareholders’ equity other than
    - the hedging reserve relating to cash flow hedges,
    - designated reserves and
    - investment revaluation reserve of the Clearing House Funds and Compensation Fund Reserve Account net of applicable deferred taxes.
  - The adjusted capital of the Group at 31 December 2006 was \$4,589,071,000 (2005: \$3,638,142,000, as restated).
  - The increase of adjusted capital was due to the increase in retained earnings and reserves.



# Capital Disclosures – Transition

- Entities shall apply the amendments of capital disclosure for
  - annual periods beginning on or after 1 January 2007.
- Early application is encouraged.



# Today's Agenda

Financial Instruments: Disclosures  
(HKFRS 7)



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## Introduction

- The objective of HKFRS 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
- 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, andhow the entity manages those risks.

### Significance

- Balance sheet
- Income statement
- Other disclosures

### Nature and Extent

- Qualitative disclosures
- Quantitative disclosures

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## Introduction: Amended by HKFRS 7

- HKFRS 7 supersedes (from 1 Jan. 2007)
  - Full HKAS 30
  - Para. 51 to 95 of HKAS 32
- As compared with HKAS 30 and 32, HKFRS 7 has the following attributes:
  1. Apply to all entities while HKAS 30 applies to financial institution only
  2. Is more correlation with the categories of financial instruments as defined in HKAS 39
  3. Aim at simplifying the disclosure requirements of HKAS 32 on risks but introduced some new disclosures .....
  4. HKAS 32 has exemption for comparative on first year of adoption but HKFRS 7 only provides exemption on the nature and extent of risks.

Significance

Nature and Extent

## Introduction: Classes and Level

- When HKFRS 7 requires disclosures by class of financial instrument, an entity shall group financial instruments into classes
  - that are appropriate to the nature of the information disclosed and
  - that take into account the characteristics of those financial instruments.
- An entity shall provide sufficient information
  - to permit reconciliation to the line items presented in the balance sheet.

Significance

Nature and Extent

The classes described above are determined by the entity and are, thus, distinct from the categories of financial instruments specified in HKAS 39 (which determine how financial instruments are measured and where changes in fair value are recognised).

## Introduction: Classes and Level

- In determining classes of financial instrument, an entity shall, at a minimum:
  - a) distinguish instruments measured at amortised cost from those measured at fair value.
  - b) treat as a separate class or classes those financial instruments outside the scope of HKFRS 7.



Significance

Nature and Extent

## Introduction: Classes and Level

- An entity decides, in the light of its circumstances,
  - how much detail it provides to satisfy the requirements of HKFRS 7,
  - how much emphasis it places on different aspects of the requirements and
  - how it aggregates information to display the overall picture without combining information with different characteristics.
- It is necessary to strike a balance between
  - overburdening financial statements with excessive detail that may not assist users of financial statements and
  - obscuring important information as a result of too much aggregation.



Significance

Nature and Extent

# 1. Significance of Financial Instruments

- 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.

Significance

Balance Sheet

Income Statement and Equity

Other Disclosures



# 1. Significance of Financial Instruments

Balance Sheet

The carrying amounts of each of the following categories, as defined in HKAS 39, shall be disclosed either on the face of the balance sheet or in the notes:

- financial assets at fair value through P/L, showing separately
  - those designated as such upon initial recognition and
  - those classified as held for trading in accordance with HKAS 39;
- held-to-maturity investments;
- loans and receivables;
- available-for-sale financial assets;
- financial liabilities at fair value through P/L, showing separately
  - those designated as such upon initial recognition and
  - those classified as held for trading in accordance with HKAS 39; and
- financial liabilities measured at amortized cost.

New in HKFRS 7

New in HKFRS 7

HKAS 32 only requires such disclosures

# 1. Significance of Financial Instruments

## Balance Sheet

Information is required to disclose on:

- Loan and receivable designated as at fair value through profit or loss (HKFRS 7.9)
- Financial liability designated as at fair value through profit and loss (HKFRS 7.10)

Designated as at Fair Value through profit or loss



# 1. Significance of Financial Instruments

## Balance Sheet

Information is required to disclose on:

- Loan and receivable designated as at fair value through profit or loss (HKFRS 7.9)

Designated as at Fair Value through profit or loss

If an entity has the above loan and receivable, it shall disclose certain information relating to credit risk, including:

- a. Maximum exposure to credit risk at the reporting date
- b. Amount by which any related credit derivative or similar instruments mitigate that maximum exposure to credit risk
- c. Amount of change (for the period and cumulative) in the fair value of the loan and receivable that is attributable to changes in credit risk of the item
- d. Amount of change in the fair value of any related credit derivative or similar instruments that has occurred (for the period and cumulative)

# 1. Significance of Financial Instruments

## Balance Sheet

Information is required to disclose on:

- Financial liability designated as at fair value through profit and loss (HKFRS 7.10)

Designated as at  
Fair Value through  
profit or loss

If an entity has the above financial liability, it shall disclose certain information relating to credit risk, including:

- a. Amount of change (for the period and cumulative) in the fair value of the financial liability that is attributable to changes in credit risk of the item
- b. the difference between
  - the financial liability's carrying amount and
  - the amount the entity would be contractually required to pay at maturity to the holder of the obligation

# 1. Significance of Financial Instruments

## Balance Sheet

### Reclassification

- If the entity has reclassified a financial asset as one measured:



- a) at cost or amortised cost, rather than at fair value; or
- b) at fair value, rather than at cost or amortised cost,

it shall disclose

- the amount reclassified into and out of each category and
- the reason for that reclassification (see HKAS 30.51–54).

# 1. Significance of Financial Instruments

## Balance Sheet

### Derecognition

- An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition (see HKAS 39.15–37 ).
  - The entity shall disclose for each class of such financial assets:
    - a) the nature of the assets;
    - b) the nature of the risks and rewards of ownership to which the entity remains exposed;
    - c) when the entity continues to recognise all of the assets, the carrying amounts of the assets and of the associated liabilities; and
    - d) when the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

# 1. Significance of Financial Instruments

## Balance Sheet



### Collateral

- An entity shall disclose:
  - a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with HKAS 39.37(a); and
  - b) the terms and conditions relating to its pledge.
- When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it shall disclose:
  - a) the fair value of the collateral held;
  - b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and
  - c) the terms and conditions associated with its use of the collateral.

# 1. Significance of Financial Instruments

## Balance Sheet

### Allowance account for credit losses (say impairment loss)

- When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g. an allowance account used) rather than directly reducing the carrying amount of the asset,
  - it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.

No reconciliation required in HKAS 32.94(i) .....



# 1. Significance of Financial Instruments

## Case

Early adopted HKFRS 7 in 2005 and its annual report 2006 states that (extract only):



- The carrying amounts of accounts receivable and deposits approximated their fair values.
- The movements in provision for impairment losses of trade receivables were as follows:

	Group	
	2006 \$'000	2005 \$'000
At 1 Jan	4,329	5,167
Provision for/(reversal of provision for) impairment losses of trade receivables (note 11)	350	(389)
Trade receivables written off during the year as uncollectible	–	(449)
At 31 Dec	4,679	4,329

# 1. Significance of Financial Instruments

## Balance Sheet

### Compound financial instruments with multiple embedded derivatives

- If an entity has issued an instrument that contains both a liability and an equity component (see HKAS 32.28) and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument),
  - it shall disclose the existence of those features.

Similar requirement in HKAS 39.94(d)



# 1. Significance of Financial Instruments

## Balance Sheet

### Defaults and Breaches

- For loans payable recognised at the reporting date, an entity shall disclose:
  - a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;
  - b) the carrying amount of the loans payable in default at the reporting date; &
  - c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.
- If, during the period, there were breaches of loan agreement terms other than those described above, an entity shall disclose
  - the same information as required by above if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date).

# 1. Significance of Financial Instruments

## Income Statement and Equity

An entity shall disclose the following items either on the face of the financial statements or in the notes:

- a) net gains or net losses on:
  - i) financial assets or financial liabilities at fair value through P/L, showing separately
    - those on financial assets or financial liabilities designated as such upon initial recognition, and
    - those on financial assets or financial liabilities that are classified as held for trading in accordance with HKAS 39;
  - ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised directly in equity during the period and the amount removed from equity and recognised in profit or loss for the period;
  - iii) held-to-maturity investments;
  - iv) loans and receivables; and
  - v) financial liabilities measured at amortized cost

New in  
HKFRS 7

HKAS 32  
requires  
this only

New in  
HKFRS 7

# 1. Significance of Financial Instruments

## Income Statement and Equity

An entity shall disclose the following items either on the face of the financial statements or in the notes:

- b) total interest income and total interest expense for financial assets or financial liabilities that are not at fair value through P/L;
- c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:
  - i) financial assets or financial liabilities that are not at fair value through profit or loss; and
  - ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;
- d) interest income on impaired financial assets accrued in accordance with HKAS 39.AG93, and
- e) the amount of any impairment loss for each class of financial asset.



New in  
HKFRS 7

# 1. Significance of Financial Instruments

## Other Disclosures

- Disclosure requirements on accounting policies, hedge accounting and fair value are similar to HKAS 32.
- HKFRS 7 additionally requires:
  - a) in fair value hedges, gains or losses:
    - i) on the hedging instrument; and
    - ii) on the hedged item attributable to the hedged risk.
  - b) the ineffectiveness recognised in profit or loss that arises from cash flow hedges; and
  - c) the ineffectiveness recognised in profit or loss that arises from hedges of net investments in foreign operations.

New in  
HKFRS 7



# 2. Nature and Extent of Risks



Significance

Nature and Extent

## 2. Nature and Extent of Risks



- 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.

Nature and Extent

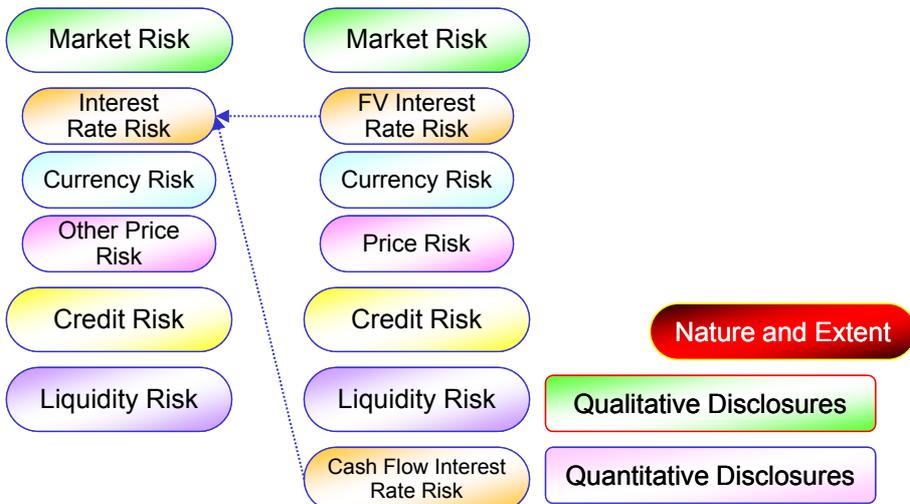
Qualitative Disclosures

Quantitative Disclosures

## 2. Nature and Extent of Risks

In HKFRS 7

In HKAS 32



## 2. Nature and Extent of Risks

### 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.



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## 2. Nature and Extent of Risks

### Quantitative Disclosures

- For each type of risk arising from financial instruments, an entity shall disclose:
  - a. 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 HKAS 24 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.
  - b. the disclosures required in quantitative disclosures, to the extent not provided in (a), unless the risk is not material (see HKAS 1.29-31).
  - c. concentrations of risk if not apparent from (a) and (b)



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## 2. Nature and Extent of Risks

### Quantitative Disclosures

- **Concentrations of risk** arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions.
- The identification of concentrations of risk requires judgement taking into account the circumstances of the entity.
- Disclosure of concentrations of risk shall include:
  - a) a description of how management determines concentrations;
  - b) a description of the shared characteristic that identifies each concentration (eg counterparty, geographical area, currency or market); and
  - c) the amount of the risk exposure associated with all financial instruments sharing that characteristic.



## 2. Nature and Extent of Risks

### Quantitative Disclosures

- 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.

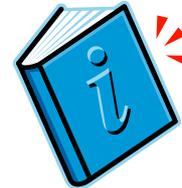


## 2. Nature and Extent – Credit Risk

### 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 HKAS 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.



## 2. Nature and Extent – Credit Risk

### Example

- Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to:
  - a) granting loans and receivables to customers and placing deposits with other entities.  
(the maximum exposure to credit risk is the carrying amount of the related financial assets)
  - b) entering into derivative contracts, eg foreign exchange contracts, interest rate swaps and credit derivatives.  
(the maximum exposure to credit risk at the reporting date will equal the carrying amount)
  - c) granting financial guarantees.  
(the maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on)
  - d) making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change.  
(the maximum credit exposure is the full amount of the commitment)

## 2. Nature and Extent – Credit Risk

### Case

Early adopted HKFRS 7 in 2005 and its annual report 2006 states that (extract only):



- Exposure to credit risk - as at 31 Dec., the financial assets and financial liabilities of the Group and HKEx that were exposed to credit risk and their maximum exposure were as follows:

	Group		Group	
	2006	2006	2005 (As restated)	2005 (As restated)
	Carrying amount in balance sheet \$'000	Maximum exposure to credit risk \$'000	Carrying amount in balance sheet \$'000	Maximum exposure to credit risk \$'000
Financial assets				
Clearing House Funds:				
Available-for-sale financial assets	317,212	317,212	224,137	224,137
Time deposits with original maturities over three months	-	-	30,290	30,290
Cash and cash equivalents	1,957,229	1,957,229	1,091,233	1,091,233
Compensation Fund Reserve Account:				
Available-for-sale financial assets	42,990	42,990	18,488	18,488
Cash and cash equivalents	8,653	8,653	30,240	30,240
Time deposit with maturity over one year	38,886	38,886	38,768	38,768
Other financial assets	18,583	18,583	17,162	17,162

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## 2. Nature and Extent – Past Due

### Quantitative Disclosures

#### 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.



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## 2. Nature and Extent – Past Due

### Case

Early adopted HKFRS 7 in 2005 and its annual report 2006 states that (extract only):



(iv) Financial assets that were past due but not impaired

As at 31 December, the age analysis of the trade receivables of the Group that were past due but not determined to be impaired according to the period past due was as follows:

	Group	
	2006 \$'000	2005 \$'000
Up to 6 months	186,359	141,277
Over 6 months to 1 year	–	–
Over 1 year to 3 years *	–	8,521
Over 3 years *	8,651	142
<b>Total</b>	<b>195,010</b>	<b>149,940</b>

\* No provision for impairment losses has been made against trade receivables amounting to \$8,510,000 (2005: \$8,521,000) as the balances can be recovered from the Clearing House Funds.

## 2. Nature and Extent – Collateral

### Quantitative Disclosures

#### Collateral and other credit enhancements obtained

- When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (eg guarantees), and such assets meet the recognition criteria in other Standards, an entity shall disclose:
  - a) the nature and carrying amount of the assets obtained; and
  - b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.



## 2. Nature and Extent – Liquidity Risk

### 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).



- The amounts disclosed in the maturity analysis are the contractual undiscounted cash flows, say gross finance lease obligation
- Such undiscounted cash flows differ from the amount included in the balance sheet because the balance sheet amount is based on discounted cash flows.

## 2. Nature and Extent – Liquidity Risk

### Example

#### Contractual Maturity Analysis

- In preparing the contractual maturity analysis for financial liabilities required by HKFRS 7.39(a), an entity uses its judgement to determine an appropriate number of time bands.
- For example, an entity might determine that the following time bands are appropriate:
  - a) not later than one month;
  - b) later than one month and not later than three months;
  - c) later than three months and not later than one year; and
  - d) later than one year and not later than five years.

## 2. Nature and Extent – Liquidity Risk

### Example

#### Contractual Maturity Analysis

- When a counterparty has a choice of when an amount is paid,
  - the liability is included on the basis of the earliest date on which the entity can be required to pay.
  - For example, financial liabilities that an entity can be required to repay on demand (eg demand deposits) are included in the earliest time band.
- When an entity is committed to make amounts available in instalments,
  - each instalment is allocated to the earliest period in which the entity can be required to pay.
  - For example, an undrawn loan commitment is included in the time band containing the earliest date it can be drawn down.

## 2. Nature and Extent – Liquidity Risk

### Case

Early adopted HKFRS 7 in 2005 and its annual report 2006 states that (extract only):



- The financial liabilities of the Group and HKEx as at 31 Dec. 2006 are analysed into relevant maturity buckets based on their contractual maturity dates in the table below:

	Group					Total
	2006					
	Up to 1 month \$'000	>1 month to 3 months \$'000	>3 months to 1 year \$'000	>1 year to 5 years \$'000	Not determinable \$'000	
Current liabilities						
Margin deposits from Clearing Participants on derivatives contracts	21,666,474	-	-	-	-	21,666,474
Accounts payable, accruals and other liabilities	11,042,527	45,937	234	363	18,139	11,107,200
Participants' admission fees received	700	50	600	-	350	1,700
	32,709,701	45,987	834	363	18,489	32,775,374

## 2. Nature and Extent – Market Risk

### Quantitative Disclosures

#### Market risk

- HKFRS 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

#### Market risk

- is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices.
- comprises three types of risk: currency risk, interest rate risk and other price risk.



## 2. Nature and Extent – Sensitivity

### 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.

Assuming that a **reasonably possible change** in the relevant risk variable had occurred at the balance sheet date and had been applied to the risk exposures in existence at that date.



## 2. Nature and Extent – Sensitivity

### Quantitative Disclosures

#### Market risk – Sensitivity Analysis for Each Type of Market Risk

- For each type of market risk, an entity decides:
  - how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments.
- For example, an entity that trades financial instruments might disclose
  - Sensitivity analysis for each type of market risk separately for
    - financial instruments held for trading and
    - those not held for trading.
- If an entity has exposure to only one type of market risk in only one economic environment,
  - it would not show disaggregated information.

## 2. Nature and Extent – Sensitivity

### Quantitative Disclosures

#### Market risk – Sensitivity Analysis for Each Type of Market Risk

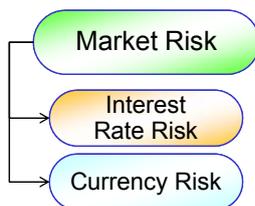
- In determining what a reasonably possible change in the relevant risk variable is, an entity should consider:
  - a. the economic environments in which it operates.
  - b. the time frame over which it is making the assessment.
- A reasonably possible change should not include remote or “worst case” scenarios or “stress tests”.
- Moreover, if the rate of change in the underlying risk variable is stable, the entity need not alter the chosen reasonably possible change in the risk variable.
- The sensitivity analysis shall show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period.

## 2. Nature and Extent – Sensitivity

### Example

- Assume that interest rates are 5% and an entity determines that a fluctuation in interest rates of  $\pm 50$  basis points is reasonably possible.
  - It would disclose the effect on profit or loss and equity if interest rates were to change to 4.5% or 5.5%.
  
- In the next period, interest rates have increased to 5.5% and the entity continues to believe that interest rates may fluctuate by  $\pm 50$  basis points (ie that the rate of change in interest rates is stable).
  - The entity would disclose the effect on profit or loss and equity if interest rates were to change to 5% or 6%.
  - The entity would not be required to revise its assessment that interest rates might reasonably fluctuate by  $\pm 50$  basis points, unless there is evidence that interest rates have become significantly more volatile.

## 2. Nature and Extent – Sensitivity



- **Interest rate risk** arises
  - on interest-bearing financial instruments recognised in the balance sheet (e.g. loans and receivables and debt instruments issued) and
  - on some financial instruments not recognised in the balance sheet (e.g. some loan commitments).
  
- **Currency risk (or foreign exchange risk)** arises on financial instruments that are denominated in a foreign currency, i.e. in a currency other than the functional currency in which they are measured.
  - For the purpose of HKFRS 7, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.
  - A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

## 2. Nature and Extent – Sensitivity

Market Risk

Other Price Risk

- **Other price risk** arises on financial instruments because of changes in, for example:
  - commodity prices or
  - equity prices.
- To comply with HKFRS 7, an entity might disclose the effect of a decrease in a specified variable, including:
  - stock market index,
  - commodity price, or
  - other risk variable.
- For example,
  - if an entity gives residual value guarantees that are financial instruments, the entity discloses an increase or decrease in the value of the assets to which the guarantee applies.

## 2. Nature and Extent – Sensitivity

Market Risk

Other Price Risk

- Examples of financial instruments that give rise to equity price risk are
  - a) a holding of equities in another entity and
  - b) an investment in a trust that in turn holds investments in equity instruments.
- Other examples include
  - forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices.
    - The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.

## 2. Nature and Extent – Sensitivity

Market Risk

Other Price Risk

- In accordance with HKFRS 7.40(a),
  - the sensitivity of profit or loss (that arises, for example, from instruments classified as at fair value through profit or loss and impairments of available-for-sale financial assets) is disclosed separately from
  - the sensitivity of equity (that arises, for example, from instruments classified as available for sale).
- Financial instruments that an entity classifies as equity instruments are not remeasured.
  - Neither profit or loss nor equity will be affected by the equity price risk of those instruments.
  - Accordingly, no sensitivity analysis is required.

## 2. Nature and Extent – Sensitivity

Example

Market Risk

Interest Rate Risk

Currency Risk

Other Price Risk

Equity Price Risk

Commodity Price Risk

Prepayment Risk

Residual Value Risk

**Risk variables that are relevant to disclosing market risk**

Yield curve of market interest rates

Foreign exchange rates

Prices of equity instruments

Market prices of commodities

## 2. Nature and Extent – Sensitivity

Example

### Example of financial assets and liabilities

- Investment in bonds, bank deposits, interest-bearing borrowings, bank loans
- Trade receivables and payables in foreign currency, foreign loans
- Investments in equity securities and equity funds, equity-linked investments
- Investments in commodity funds and commodity-linked investments

### Risk variables that are relevant to disclosing market risk

Yield curve of market interest rates

Foreign exchange rates

Prices of equity instruments

Market prices of commodities

## 2. Nature and Extent – Sensitivity

Example

### Example of financial assets and liabilities

- Investment in bonds, bank deposits, interest-bearing borrowings, bank loans

### Risk variables that are relevant to disclosing market risk

Yield curve of market interest rates

- For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on:
  - a) interest income and expense;
  - b) other line items of profit or loss (such as trading gains and losses); and
  - c) when applicable, equity.
- An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk.

## 2. Nature and Extent – Sensitivity

Example

Identify

- the items that sensitivity analysis is required and
- the relevant risk variables?

<u>Sample Inc.</u>	<u>2007</u>	<u>2006</u>
Fixed assets – PPE	\$ 15,000	\$ 12,000
Investments in 5% bond	5,000	4,500
Investments in equity securities	5,000	4,000
Trade and other receivables	10,000	9,000
Fixed deposits	1,000	800
Cash at bank	1,800	2,200
Trade and other payables	(3,000)	(2,500)
Bank loans and overdrafts	<u>(4,800)</u>	<u>(3,000)</u>
	<u>30,000</u>	<u>27,000</u>
Issued equity	\$ 10,000	\$ 10,000
Retained earnings	<u>20,000</u>	<u>17,000</u>
	<u>30,000</u>	<u>27,000</u>

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## 2. Nature and Extent – Sensitivity

Example

### Interest rate risk

- At 31 Dec. 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant,
  - post-tax profit for the year would have been \$1.7 million (20X1: \$2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings, and
  - other components of equity would have been \$2.8 million (20X1: \$3.2 million) higher, arising mainly as a result of an increase in the fair value of fixed rate financial assets classified as available for sale.
- If interest rates had been 10 basis points higher, with all other variables held constant,
  - post-tax profit would have been \$1.5 million (20X1: \$2.1 million) lower, arising mainly as a result of higher interest expense on variable borrowings, and
  - other components of equity would have been \$3.0 million (20X1: \$3.4 million) lower, arising mainly as a result of a decrease in the fair value of fixed rate financial assets classified as available for sale.

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## 2. Nature and Extent – Sensitivity

### Example

#### Interest rate risk

- Profit is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates.
- The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X).



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## 2. Nature and Extent – Sensitivity

### Case

#### KPMG HK: Illustrative Financial Statements under HKFRSs (2007.12)

##### Sensitivity Analysis

- At 31 December 2007, it is estimated that a general increase/decrease of [...] basis points in interest rates, with all other variables held constant, would decrease/increase the group's profit after tax and retained profits by approximately \$[...] (2006: \$[...]).
- Other components of consolidated equity would increase/decrease by approximately \$[...] (2006: \$[...]) in response to the general increase/decrease in interest rates.
- The sensitivity analysis above has been determined assuming that the change in interest rates had occurred at the balance sheet date and had been applied to the exposure to interest rate risk for both derivative and non-derivative financial instruments in existence at that date. The [...] basis point increase or decrease represents management's assessment of a reasonably possible change in interest rates over the period until the next annual balance sheet date.
- The analysis is performed on the same basis for 2006.

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## 2. Nature and Extent – Sensitivity

### 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 (VaR), 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 – Sensitivity

### Quantitative Disclosures

#### Market risk – Sensitivity Analysis That Reflects Interdependencies Between Risks Variables

- An entity might comply the VaR methodology by disclosing
  - the type of VaR model used (e.g. whether the model relies on Monte Carlo simulations),
  - an explanation about how the model works and
  - the main assumptions (eg the holding period and confidence level).
- Entities might also disclose
  - the historical observation period and weightings applied to observations within that period,
  - an explanation of how options are dealt with in the calculations, and
  - which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

## 2. Nature and Extent – Sensitivity

### Quantitative Disclosures

- Common approaches in estimating **Value at Risk (VaR)**
  - Variance-covariance approach
    - Same theoretical basis as portfolio theory and more straightforward
    - Weaknesses: not good at returns with non-linear or non-normal elements, say options
  - Historical simulation
    - Uses historical data to re-produce the distribution of return and no normality assumption
    - Weaknesses: depending on actual data observed
  - Monte Carlo simulation
    - Estimated from a simulated distribution, powerful and be able to handle any type of position
    - Weaknesses: difficult to implement and time-consuming



## 2. Nature and Extent – Sensitivity

### Case

Early adopted HKFRS 7 in 2005 and its 2006 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 – Sensitivity

### Case

Early adopted HKFRS 7 in 2005 and its 2006 annual report states that (extract only):



- VaR is a statistical measure of risks and has limitations associated with the assumptions employed.
- Historical simulation assumes that actual observed historical changes in market indices, such as interest rates, foreign exchange rates and equity prices, reflect possible future changes.
- This implies that the approach is vulnerable to sudden changes in market behaviour.
- The use of a 10-day holding period assumes that the positions can be unwound in 10 trading days and the holding period may be insufficient at times of severe illiquidity.
- Also, VaR does not necessarily reflect all aspects of risks that affect the price of financial instruments and may underestimate real market risk exposure.
- In addition, VaR does not factor in the possibility of catastrophic risk but the use of stress testing for abnormal market conditions can mitigate this limitation.

## 2. Nature and Extent – Sensitivity

### Case

Early adopted HKFRS 7 in 2005 and its 2006 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					
	2006			2005		
	Average \$'000	Highest \$'000	Lowest \$'000	Average \$'000	Highest \$'000	Lowest \$'000
Foreign exchange risk	5,957	7,422	4,907	5,017	6,135	3,591
Equity price risk	11,207	13,032	8,991	8,495	11,209	6,567
Interest rate risk	11,884	13,862	9,040	20,515	24,043	14,367
Total VaR	18,751	21,005	15,939	23,451	26,869	20,383

	HKEx					
	2006			2005		
	Average \$'000	Highest \$'000	Lowest \$'000	Average \$'000	Highest \$'000	Lowest \$'000
Foreign exchange risk	794	1,245	273	222	709	-
Equity price risk	-	-	-	-	-	-
Interest rate risk	14	35	2	7	22	-
Total VaR	793	1,249	277	228	717	-

## 2. Nature and Extent – Sensitivity

### Case

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%



## 2. Nature and Extent – Sensitivity

### Example

#### Variance-Covariance Approach in VaR

- 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

## 2. Nature and Extent – Other

### 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
  - the entity shall disclose
    - that fact and
    - the reason it believes the sensitivity analyses are unrepresentative.



## 2. Nature and Extent – Other

### Example

- Sensitivity analysis disclosed may be unrepresentative of a risk inherent in a financial instrument when:
  - a) a financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis,
    - e.g. options that remain out of (or in) the money for the chosen change in the risk variable;
  - b) financial assets are illiquid,
    - e.g. when there is a low volume of transactions in similar assets and an entity finds it difficult to find a counterparty; or
  - c) an entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding.

## 2. Nature and Extent – Other

### Example

- If there is a financial instrument containing terms and conditions whose effects are not apparent from the sensitivity analysis, additional disclosure might include:
  - a) the terms and conditions of the financial instrument (eg the options);
  - b) the effect on profit or loss if the term or condition were met (ie if the options were exercised); and
  - c) a description of how the risk is hedged.

## 2. Nature and Extent – Other

### Example

- If there are illiquid financial assets, additional disclosure might include the reasons for the lack of liquidity and how the entity hedges the risk.
- If an entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding, additional disclosure might include:
  - a) the nature of the security (e.g. entity name);
  - b) the extent of holding (e.g. 15% of the issued shares);
  - c) the effect on profit or loss; and
  - d) how the entity hedges the risk.

### 3. Effective Date and Transition

- An entity shall apply HKFRS 7 for annual periods beginning on or after 1 January 2007.
- Earlier application is encouraged.
  - If an entity applies HKFRS 7 for an earlier period, it shall disclose that fact.
- If an entity applies HKFRS 7 for annual periods beginning before 1 January 2006,
  - it need not present comparative information for the disclosures about the nature and extent of risks arising from financial instruments.

- HKAS 32.97 requires that if comparative information for prior periods is not available when HKAS 32 is first applied,
  - such information need not be presented, but an entity shall disclose that fact.

### Today's Agenda

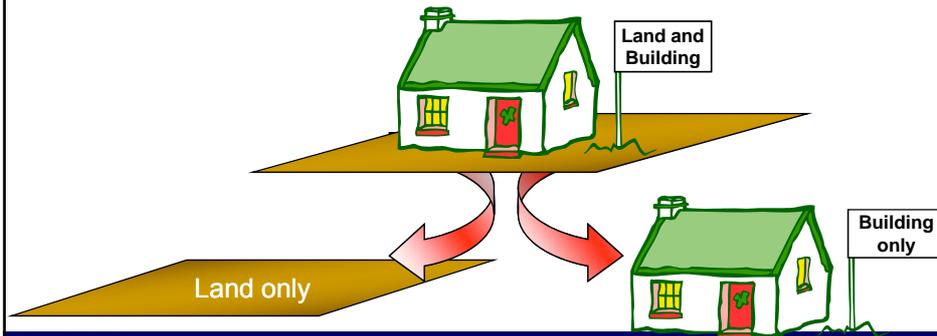
Recap Session (HKAS 17, 40 & 39)



# HKAS 17 Leases

- New requirements with significant impact, mainly .....

**Separate measurement**  
(of the land and buildings elements) at the inception of the lease



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# Leases – Separate Measurement

If a lease contains land and buildings elements

- 2 elements are considered separately for lease classification

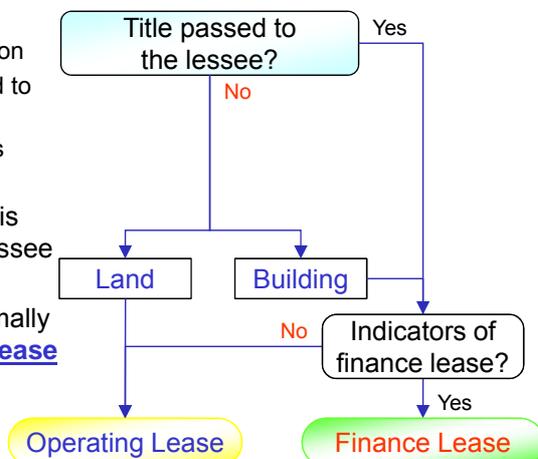
If **title** of both elements is expected to pass to the lessee

- Both elements are classified as **finance lease**

If **title** of land or both elements is **NOT** expected to pass to the lessee

- The land element alone (as having indefinite life) is normally classified as an **operating lease**
- The building element is considered separately

## Lease of land and buildings



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# Leases – Separate Measurement

## Lease of land and buildings

- To classify and account for a lease of land and buildings
  - the [minimum lease payments](#) (including any lump-sum upfront payments) are allocated between
    - the [land](#) and
    - the [buildings](#) elements
  - in proportion to the [relative fair values](#) of the leasehold interests in the land element and buildings element of the lease [at the inception of the lease](#)

### Relative Fair Value



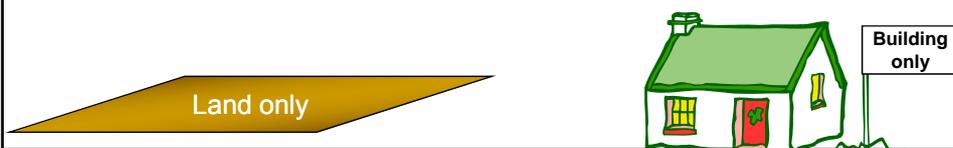
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# Leases – Separate Measurement

## Lease of land and buildings

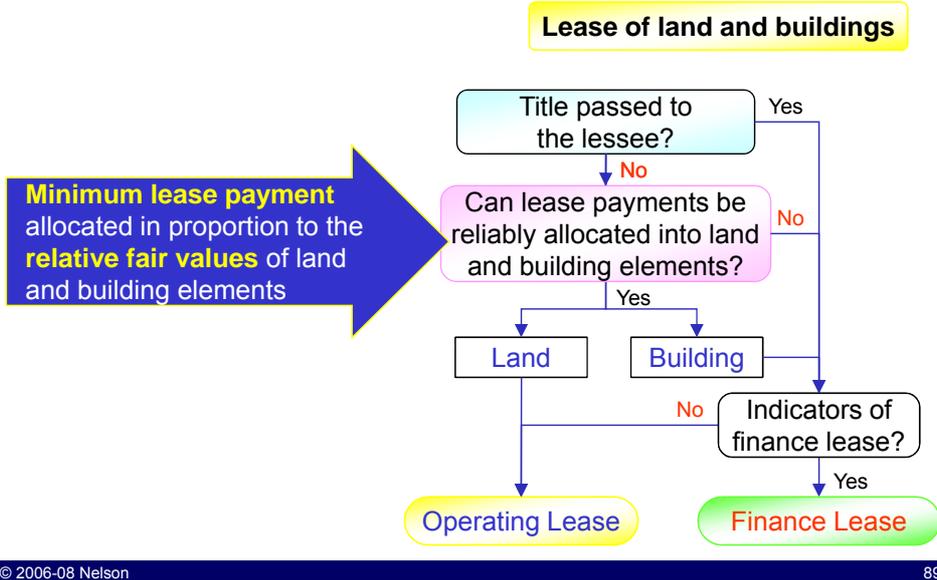
- If the lease payments cannot be allocated reliably between the 2 elements
  - the entire lease is classified as a **finance lease**
  - unless it is clear that both elements are operating leases, in which case the entire lease is classified as an [operating lease](#)
- For a lease of land and building if the land is immaterial
  - The lease may be treated as a single unit and classified as finance or operating leases



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## Leases – Separate Measurement



## HKAS 40 Investment Property

- Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:
  - a) use in the production or supply of goods or services or for administrative purposes; or
  - b) sale in the ordinary course of business



## Definitions – Extend to Operating Leases

- A property interest
  - that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if
    - the property would otherwise meet the definition of an investment property and
    - the lessee uses the Fair Value Model
- This classification alternative is available on a property-by-property basis
- However, once this classification alternative is selected for one such property interest held under an operating lease, all properties classified as investment property shall be accounted for using the Fair Value Model

← An entity has a choice



## Measurement after Recognition

Introduce Cost Model and choose either

**Fair Value Model**

and

**Cost Model**

- HKAS 40 implicitly implies that the choice can only be elected on the first-time adoption of HKAS 40
- The model chosen should be applied to all investment properties, except for some identified exceptions.
- However, even Cost Model is adopted, HKAS 40 still requires all entities to determine the fair value of investment property .....
- For disclosure purpose, the fair value of the investment property has to be disclosed in notes to the financial statement!
- In determining the fair value of investment property for both cost model and fair value model
  - ⇒ an entity is only encouraged, but not required, to rely on a professional valuer's valuation

# Measurement after Recognition

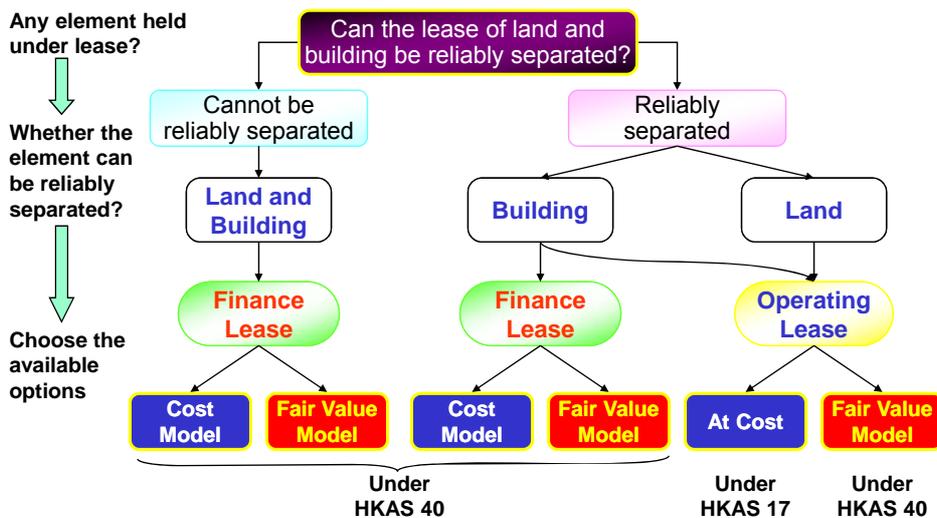
After initial recognition, an entity that chooses →

**Fair Value Model**

- shall measure all of its investment property at fair value, except in some limited cases.
    - When a property interest held by a lessee under an operating lease is classified as an investment property
      - ⇒ the fair value model must be applied for all investment properties
    - A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises
    - The fair value of investment property shall reflect market conditions at the balance sheet date
- No depreciation required in HKAS 40



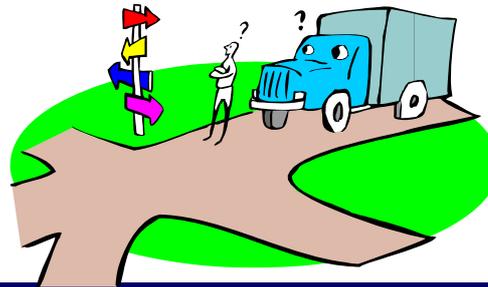
# Application of HKAS 16, 17 & 40



# Application of HKAS 16, 17 & 40

Example

- Can PPE or Investment Property in HK or PRC be carried at cost model after the adoption of HKAS 17 and HKAS 40?

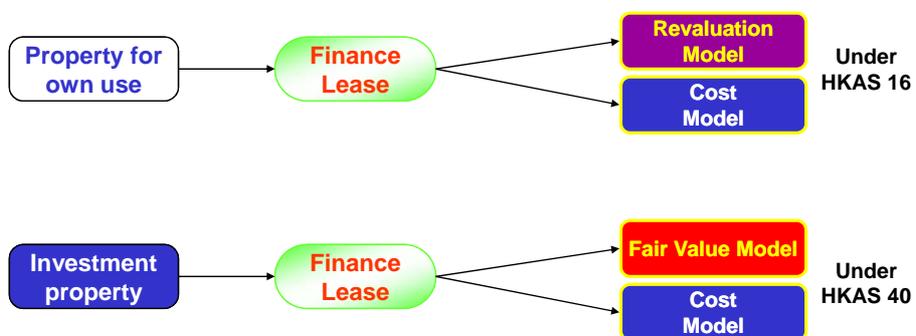


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## Application of

Land and building cannot be reliably separated

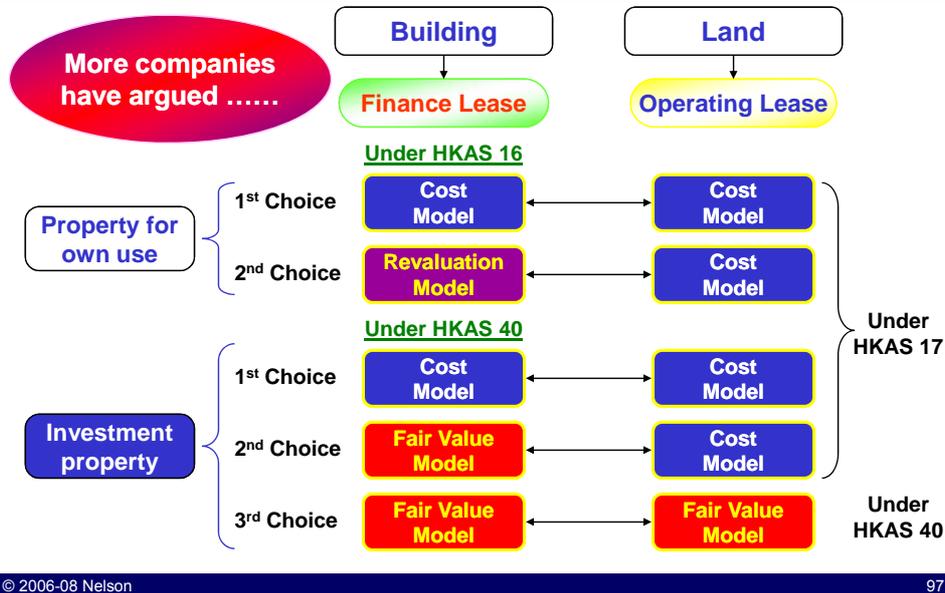


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# Application of

Land and building  
can be reliably separated



# Application of HKAS 16, 17 & 40

Example

• Can PPE or Investment Property in HK or PRC be carried at cost model after the adoption of HKAS 17 and HKAS 40?

- PPE can be carried at cost model if either:
  - The lease of land and building cannot be reliably allocated between land and building element
    - The whole lease will be
      - classified as finance lease (other than exception case) and
      - then accounted for at cost model under HKAS 16; or
  - The lease of land and building can be reliably allocated between land and building
    - The land is carried at amortised cost under HKAS 17
    - The building is carried at cost model under HKAS 16

## Application of HKAS 16, 17 & 40

### Example

- Can PPE or Investment Property in HK or PRC be carried at cost model after the adoption of HKAS 17 and HKAS 40?
  - Investment Property can be carried at cost model if either:
    - The lease of land and building cannot be reliably allocated between land and building element
      - The whole lease will be
        - classified as finance lease (other than exception case) and
        - then accounted for at cost model under HKAS 40; or
      - The lease of land and building can be reliably allocated between land and building
        - The land is carried at amortised cost under HKAS 17
        - The building is carried at cost model under HKAS 40

## Application of HKAS 16, 17 & 40

### Case



#### Annual Report 2005

- In the opinion of the directors, the lease payments of the Group cannot be allocated reliably between the land and building elements, therefore, the entire lease payments are included in the cost of land and building and are amortised over the shorter of the lease terms and useful lives.



#### Annual Report 2005

- As the Group's lease payments cannot be allocated reliably between the land and buildings elements, the entire lease payments are included in the cost of the land and buildings as a finance lease in property, plant and equipment.
- The adoption of HKAS 17 has not resulted in any change in the measurement of the Group's land and buildings.

# Today's Agenda

Recap Session (HKAS 17, 40 & 39)



## HKAS 39 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.

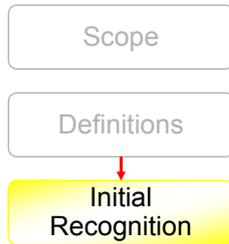
Initial Recognition

- 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

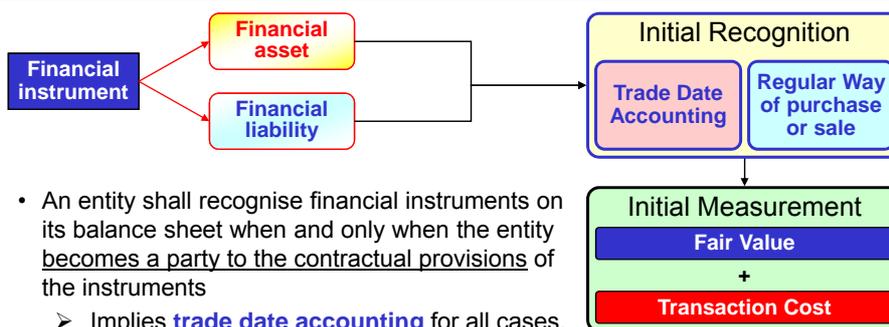
# Initial Recognition



- All financial instruments, including derivatives, are recognised in the balance sheet (on balance sheet).



# Initial Recognition & Measurement



- An entity shall recognise financial instruments on its balance sheet when and only when the entity becomes a party to the contractual provisions of the instruments
  - Implies **trade date accounting** for all cases, except for a **regular way purchase or sale** (e.g. purchase of derivatives)
- 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*)

# Initial Recognition & Measurement

## Example

### Fair value at Initial Recognition – Low Interest Loan

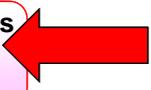
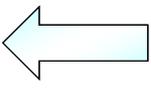
- Entity A grants a 3-year loan of HK\$50,000 to a related party, B, on 1 Jan. 2005 as one kind of financial assistance to support B's operation.
  - A charges B at a interest rate of 2% as A expects the return on B's future operation would be higher.
  - A charges another related party at a current market lending rate of 6%
- Discuss the implication of the loan.

### Fair value at Initial Recognition – No Interest Deposit

- Entity X is required to deposit HK\$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 (HKAS 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

## Example

### Fair value at Initial Recognition

- Entity A grants a loan of HK\$50,000 to a related party, B, on 1 Jan. 2005 as one kind of financial assistance to support B's operation.
  - A expects the return on B's future operation would be higher.
  - However, A has not specified the interest rate and repayment terms with Entity B.
  - A charges another related party at a current market lending rate of 6%
- Discuss the implication of the loan.



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# Initial Recognition & Measurement

### No Active Market: Valuation Technique (HKAS 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.



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# Measurement after Recognition

Scope

Definitions

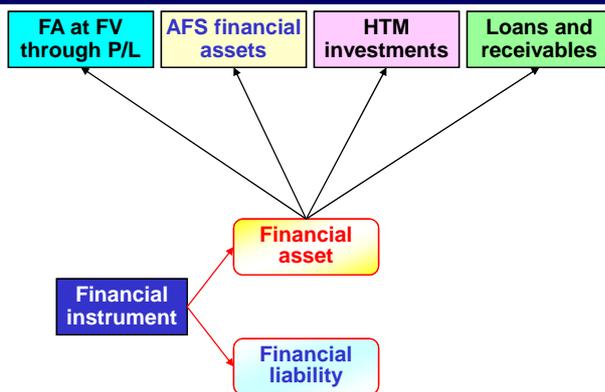
Initial Recognition

Measurement

- Except for strict conditions are fulfilled, all financial assets are measured at fair value

**4-category classification will affect the subsequent measurement of financial assets (but not the initial measurement).**

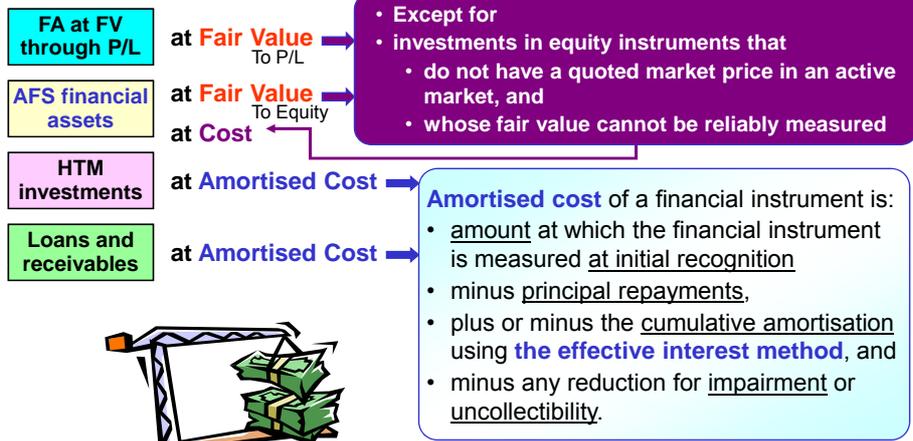
# Measurement – Classification



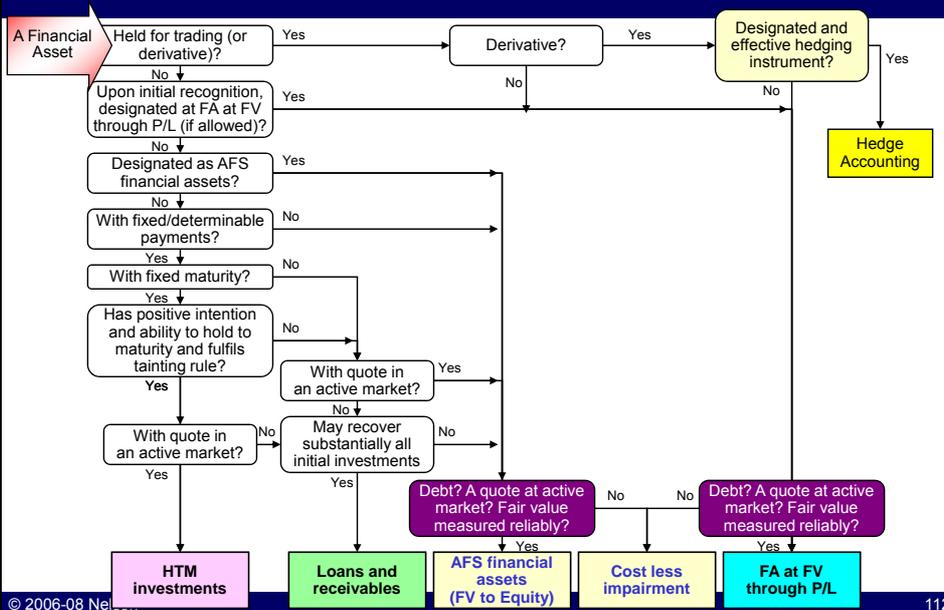
**4-category classification will affect the subsequent measurement of financial assets (but not the initial measurement).**

# Measurement after Recognition

**Classification** determine  
**Subsequent Measurement**



# Measurement after Recognition



# Measurement – Impairment

## Impairment

- FA at FV through P/L
- AFS financial assets
- HTM investments
- Loans and receivables

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 HKAS 36

- FA at FV through P/L
- AFS financial assets
- HTM investments
- Loans and receivables

at Fair Value →  
at Fair Value →  
at Cost

## Impairment (if there is objective evidence)

- Implicitly, no impairment review is needed as gain or loss on change in fair value is recognised in profit or loss

- 2 conditions to effect impairment loss
  1. when a decline in its fair value has been recognised directly in equity and
  2. there is objective evidence that it is impaired
- Then, the cumulative loss recognised directly in equity shall be
  - removed from equity and
  - recognised in profit or loss
  - even the asset has not been derecognised.

- 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 HKAS 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.

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# Measurement – Impairment

Outside the scope of HKAS 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.

Implication?

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# 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.

- HKAS 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

## Case

### **Hang Seng Bank** (2004 Annual Report)

#### Provisions for bad and doubtful debts

- On adoption of HKAS 39,
  - Impairment provisions for advances assessed individually are calculated using a discounted cash flow analysis for the impaired advances.
  - Collective assessment of impairment for individually insignificant items or items where no impairment has been identified on an individual basis is made using formula-based approaches or statistical methods.
  - Impairment provisions for advances will be presented as individually assessed and collectively assessed
    - **instead of** specific provisions and general provisions.
  - There will be no significant change in the net charge for provisions to profit and loss account.



## Measurement – Summary

	<u>Subsequent Measurement</u>	<u>Impairment</u>	<u>Reversal</u>	<u>Reclassification</u>
<b>FA at FV through P/L</b>	at Fair Value to P/L	Not required	N/A	Not allowed
<b>AFS financial assets</b>	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
<b>HTM investments</b>	at Amortised Cost	To P/L	Related objectively to an event	To AFS
<b>Loans and receivables</b>	at Amortised Cost	To P/L	Related objectively to an event	Not described in HKAS 39; implicitly, not feasible

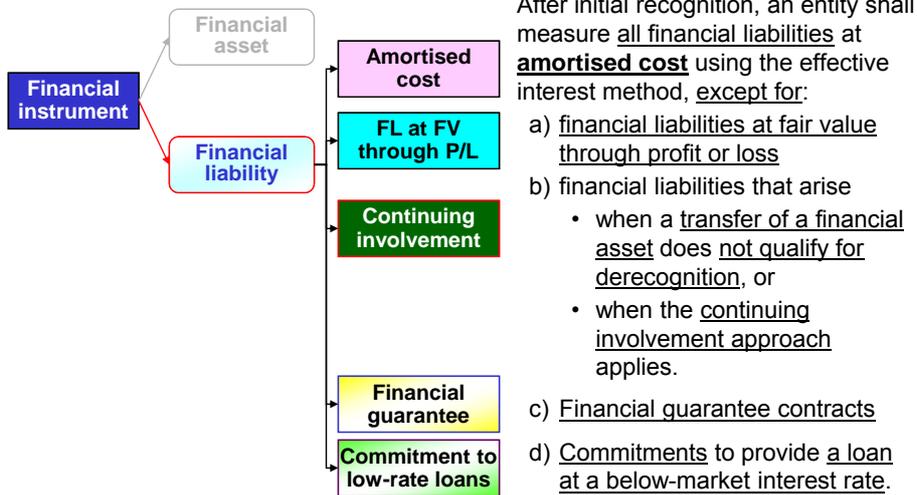
## Financial Liabilities – Measurement



Measurement

• Financial Liabilities – Subsequent Measurement

# Financial Liabilities – Measurement



# 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 HKAS 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.

Initial Recognition

Trade Date Accounting

Regular Way of Financial Assets

↓

Initial Measurement

Fair Value

+

Transaction Cost

## 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 HKAS 37 Provisions, Contingent Liabilities and Contingent Assets; and
    - ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with HKAS 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 HKAS 39
  - HKAS 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
          - HKAS 39 or
          - HKFRS 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

Financial  
guarantee

- **KPMG Singapore** (Aug. 2006):

- If a guarantee arrangement is accounted for under FRS 104 (which is based on IFRS 4 without modification) by a non-insurance entity,
  - the guarantee arrangement should be disclosed as a contingent liability.
- A liability is only recognised
  - if payment become probable.
- This treatment is consistent with the current position in accounting for financial guarantees by non insurance entities.

Asserted  
Explicitly

Used Insurance  
Accounting

## Financial Liabilities – Measurement

Case

Financial  
guarantee

### Tristate Holdings Limited

- 2006 Annual Report
  - For guarantees provided by the Company for banking facilities granted to subsidiaries, the Company
    - regards such guarantees as insurance contracts and does not recognise liabilities for financial guarantees at inception,
    - but performs a liability adequacy test at each reporting date and recognise any deficiency in the liabilities in the income statement.

## Financial Liabilities – Measurement

### Financial guarantee

- HKFRS 4 *Insurance Contracts*:

Liability adequacy test (HKFRS 4.15)

- 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 paragraphs 31 and 32) is inadequate in the light of the estimated future cash flows,
  - the entire deficiency shall be recognised in profit or loss.

## Financial Liabilities – Measurement

### Case



**Goldbond Group Holdings Ltd.** – Interim Report 2006/07:

Note 16: Financial guarantee contracts

- In July 2004, the Group granted a guarantee of US\$3,750,000, equivalent to approximately HK\$29,250,000 in respect of banking facilities granted to a jointly controlled entity.
- In May 2005, the Group entered into funding, allocation and distribution agreements in respect of a bank loan of RMB148,977,000, equivalent to approximately HK\$146,056,000 borrowed by a jointly controlled entity. Pursuant to such agreements, the Group has taken on the funding undertaking and buy-back undertakings, details of which were set out in the Company's circular dated 14 June 2005.
- At the respective date of grant, the fair value of the financial guarantee contracts was assessed by external valuers, Vigers Appraisal & Consulting Limited amounted to US\$137,000 (equivalent to approximately HK\$1,069,000) and RMB762,000 (equivalent to approximately HK\$733,000) respectively.

## 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



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.
 

Dr	Payables
Cr	Profit & loss
- 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	Profit & loss
Cr	Payables

## Financial Liabilities – Measurement

### Case

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

### Case



Note 51 “Contingent Liabilities” of 2006 Annual Report states that :

- Guarantees given and indemnities provided by the Group and the Company in respect of credit facilities granted to .....
  - Other than the guarantee provided by the Company as mentioned in item (a), the directors considered that the fair values of these financial guarantee contracts at their initial recognition are insignificant on the basis of short maturity periods and low applicable default rates.
  - The financial guarantee contracts of the Company have been recognised in the Company’s financial statements.

# Financial Liabilities – Measurement

## Case

### KPMG

The Illustrative Financial Statements for 2006

- Note 37(c) states that:
  - As at the balance sheet date, the directors do not consider it probable that a claim will be made against the company under any of the guarantees .....
  - Deferred income in respect of the single guarantees issued is disclosed in note 26.
  - The company has not recognised any deferred income in respect of the cross guarantee as its fair value cannot be reliably measured and its transaction price was \$Nil.

## Today's Agenda

Summary of Latest Development



## Forthcoming Change in 2007 – 2008



### HKAS 1 Presentation of Financial Statements

- Converged to US , finalised in IASB in Sep. 2007 and issued in HK in Dec. 2008
- Changes include:
  - A complete set of financial statements include:
    - Balance sheet → **Statement of financial position**
    - Profit and loss a/c → **Statement of comprehensive income (SCI)**
    - Cash flow statement → **Statement of cash flows**
  - But titles remain non-mandatory
  - Changes in equity divided between owner and non-owner changes in equity
  - Single statement (SCI) and two-statement (income statement and SCI) approach in presenting non-owner changes in equity .....

## Forthcoming Change in 2007 – 2008



- **IFRS 3 and IAS 27 revised in Jan. 2008**
- **Exposure Drafts to be finalised in 2008**  
(per IASB Work Plan – Project Timetable)
  - Financial Instruments: Puttable Instruments (IAS 32)
  - Related Party Disclosures (IAS 24)
  - Joint Ventures (IAS 31)
  - IFRS for SMEs
  - Earnings per Share: Treasury Stock Method (ISA 33)
  - Annual Improvement (first annual project)

Proposed 41 separate amendments affecting 25 different IFRSs

Tentative effective date:  
1 Jan. 2009

# Update & Recap on HKFRS: Part I

16 February 2008

Full set of slides in PDF can be found in  
[www.NelsonCPA.com.hk](http://www.NelsonCPA.com.hk)



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