

IAS 32, IAS 39, IFRS 4 and IFRS 7 (Part 1)

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

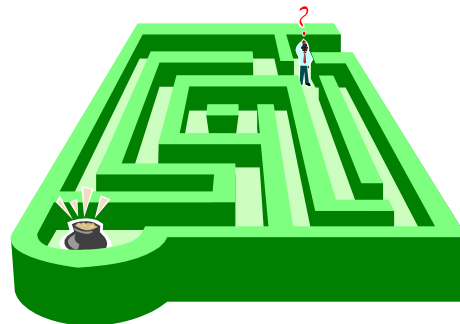
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IAS 32, IAS 39, IFRS 4 and IFRS 7

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

Professor Sir David Tweedie
Chairman of IASB



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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

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

Scope

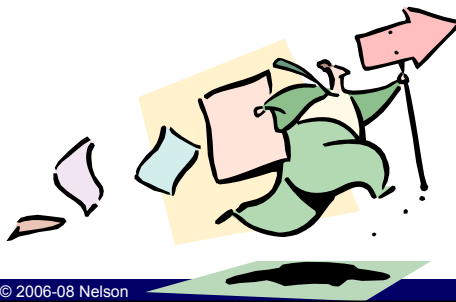
- Extended the scope to all contract to buy and sell of non-financial items that meet the scope.

Initial Recognition

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

Classification

- Classification of financial assets, financial liability and equity



Simple but Comprehensive

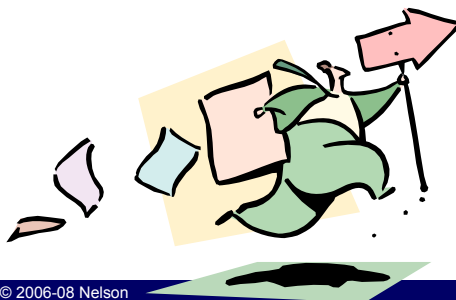
Contentious and key issues

Real Life Cases and Examples

Today's Agenda

Scope

- Extended the scope to all contract to buy and sell of non-financial items that meet the scope.



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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		×

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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
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

Forward contracts

- as if financial instruments
- within scope

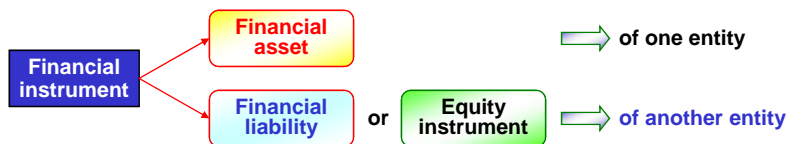
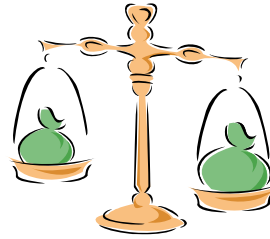
Usual executory contracts

- **NOT** within scope

Scope – What is Financial Instrument?

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



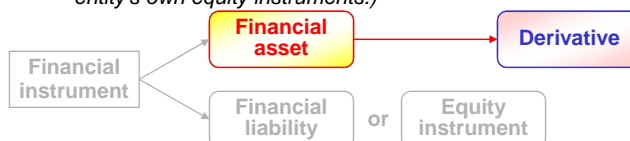
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Scope – What is Financial Instrument?

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 be 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.)*



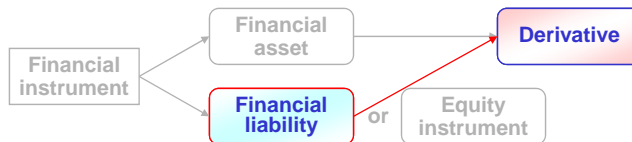
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Scope – What is Financial Instrument?

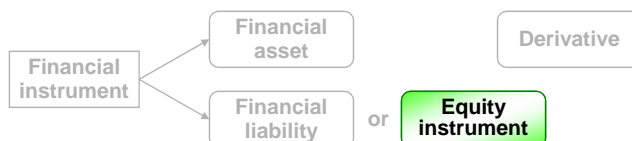
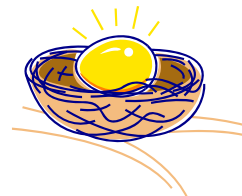
Financial liability is any liability that is

- 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 be 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.)*



Scope – What is Financial Instrument?

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



Scope – What is Financial Instrument?

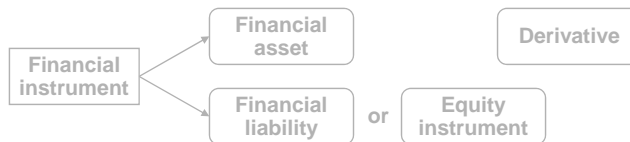
Example

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.



Scope – What is Financial Instrument?

Derivative

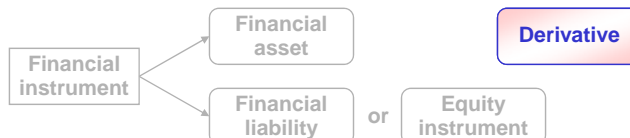
⇒ is a financial instrument or other contract within the scope of IAS 39 with all 3 of the following characteristics:

Value change based on an underlying

Little or no initial net investment

Settled at a future date

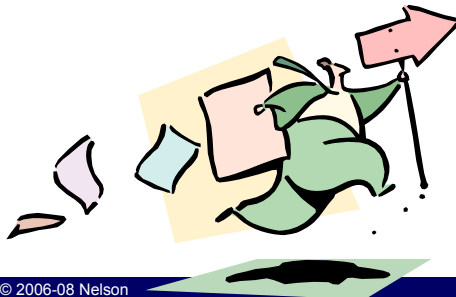
- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying');
- it requires no initial net investment or an 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
- it is settled at a future date.



Today's Agenda

Initial Recognition

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



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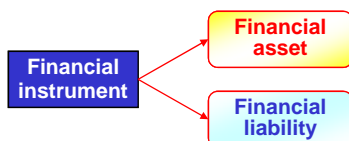
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Initial Recognition & Measurement

- Initial recognition requirements for financial assets and financial liabilities in IAS 39 are the same.
- An entity is required to 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 instrument.
- In other accounting standards, the recognition criteria are
 - 1) it is probable that future economic benefits associated with the item will flow to (or flow out from) the entity; and
 - 2) the cost of the item can be measured reliably.

Imply trade date accounting

Imply settlement date accounting

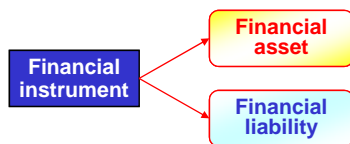


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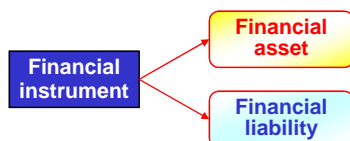
Initial Recognition & Measurement

- The settlement date is the date that an asset is delivered to or by an entity.
- The trade date is the date that an entity commits itself to purchase or sell an asset.
- The recognition criteria in IAS 39 require an entity to recognise financial asset or financial liability when it becomes a party to the contractual provisions of the instruments.
 - These criteria imply an entity to recognise financial asset or financial liability on a trade date basis.



Initial Recognition & Measurement

- In consequence of the recognition criteria of IAS 39, all the financial assets and liabilities, including derivatives (such as options and futures), become “on-balance sheet” from the trade date.
 - In other words, an entity is also required to recognise all of its contractual rights and obligations under derivatives in its balance sheet as assets and liabilities.



Initial Recognition & Measurement

- For financial assets, an entity can choose to recognise and derecognise a financial asset either using trade date accounting or settlement date accounting if it is a regular way purchase or sale of financial asset
- 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.



Initial Recognition & Measurement

- IAS 39 specifically states that a contract that requires or permits net settlement of the change in the value of the contract (such as derivative contract) is not a regular way contract.
 - Such contract is accounted for as a derivative in the period between the trade date and the settlement date.
- No matter which accounting method is used for a regular way purchase or sale, the method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets.



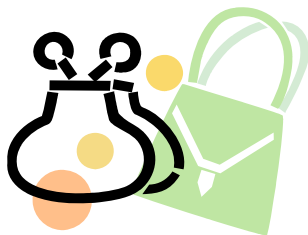
Initial Recognition & Measurement

- For both financial assets and financial liabilities, IAS 39 has
 - the same initial recognition requirements
 - the same initial measurement basis
- When a financial asset or financial liability (except for it at fair value through profit or loss) is recognised initially, an entity is required to measure it at:
 1. its **fair value** plus
 2. its **transactions costs** that are directly attributable to the acquisition or issue of the financial asset or financial liability



Initial Recognition & Measurement

- In the case of a financial asset or financial liability that will be classified as financial asset or financial liability at fair value through profit or loss,
 - an entity is only required to measure it at its fair value only
 - its transaction costs should not be recognised.



Initial Recognition & Measurement

- 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.
- Transaction costs
 - are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.
 - An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.



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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 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 \$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.

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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



Determination of Fair Value (Annual Report 2006)

- All financial instruments are recognised initially at fair value.
- 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.
- In certain circumstances, however, the initial fair value may be based
 - on other observable current market transactions in the same instrument, without modification or repackaging, or
 - on a valuation technique whose variables include only data from observable markets.

Initial Recognition & Measurement

Case



- **Accounting report 2006**

Held-to-maturity financial assets

- Held-to-maturity financial assets are non-derivative financial assets that comprise fixed or determinable payments and maturities of which the Group has the positive intention and ability to hold until maturity.
 - Investments intended to be held for an undefined period are not included in this classification.
 - These investments are initially recognized at cost, being the fair value of the consideration paid for the acquisition of the investment.
 - All transaction costs directly attributable to the acquisition are also included in the cost of the investment.

Initial Recognition & Measurement

Example

- Advance Finance Inc. originates a loan of \$1 million that bears an off-market interest rate, 6% per annum, when the market rate for similar loans is 8%, and receives an up-front fee of \$250,000 as compensation.
- Advance Finance Inc. should recognise the loan at its fair value, i.e. net of the fee it receives, at \$750,000 (\$1,000,000 - \$250,000).
- While cash interest of \$60,000 per annum will be received, the effective interest rate is still 8% per annum ($\$60,000 \div \$750,000$).

Initial Recognition & Measurement

Example

- Advance Finance Inc. grants a 3-year loan of \$50,000 to a new customer on 1 January 2008.
- Advance Finance Inc. charges the interest at 4% per annum as it expects to generate more new business from this new customer.
- The current market lending rate of a similar loan is 6% per annum.
- Discuss the implication of the loan.

Initial Recognition & Measurement

Example

- On initial recognition, Advance Finance Inc. should recognise the loan receivable at the fair value.
- Even the best evidence of the fair value of the loan at initial recognition is the transaction price but part of the consideration given is for something other than the loan, the fair value of the loan should be estimated using a valuation technique.
- The fair value of the loan receivable can be estimated as the present value of all future cash receipts discounted using the prevailing market interest rate for a similar instrument.
- By using the market interest rate of 6% for a similar loan, Advance Finance Inc. derives the present value of the interests and principal repayments as follows:

	<u>Cash inflow</u>	<u>Discount factor</u>	<u>Present value</u>
2008	\$ 2,000	$1 \div (1+6\%)^1$	\$ 1,887
2009	2,000	$1 \div (1+6\%)^2$	1,780
2010	2,000	$1 \div (1+6\%)^3$	1,679
2010	50,000	$1 \div (1+6\%)^3$	<u>41,981</u>
	Present value of all future cash receipts		<u>47,327</u>

Initial Recognition & Measurement

Example

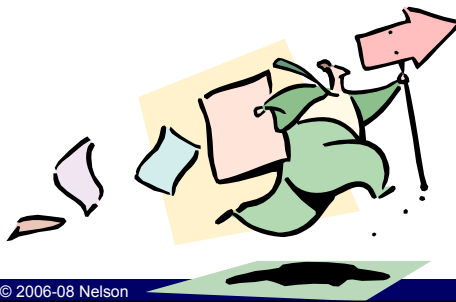
- Discounting the interest and principal repayments using the market rate of 6%, Advance Finance Inc. will recognise an originated loan of \$47,327. The difference of \$2,673 between \$50,000 and \$47,327 may represent the value of future business with the customer. However, it does not qualify for recognition as an asset and should be expensed immediately. Advance Finance Inc. recognises the loan receivable as follows:

Dr	Financial asset	\$47,327	
	Profit or loss	2,673	
Cr	Cash		\$50,000

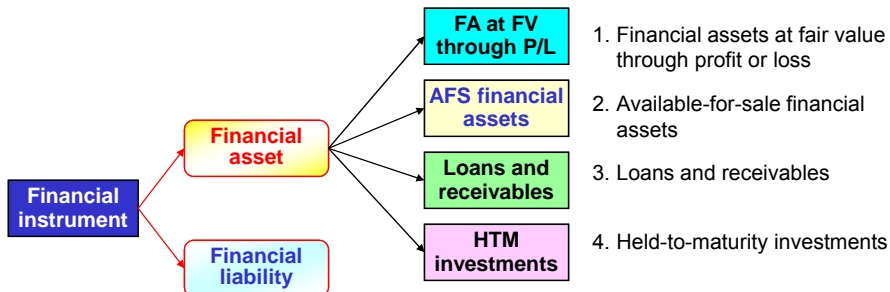
Today's Agenda

Classification

- Classification of financial assets, financial liability and equity



Classification and Definitions



- Initial recognition and measurement principle for financial assets and financial liabilities are the same
- 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.

Classification and Definitions

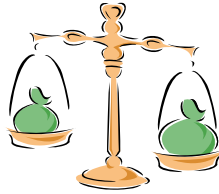
Case



Financial instruments – initial recognition (Annual Report 2006)

- The Group classifies its financial instruments into different categories at inception, depending on the purpose for which
 - the assets were acquired or
 - the liabilities were incurred.
- The categories are:
 - fair value through profit or loss,
 - loans and receivables,
 - held-to-maturity investments,
 - available-for-sale financial assets and
 - other financial liabilities.

Classification and Definitions



- For the purpose of our discussion, five categories are used and explained for subsequent measurement of financial assets
 - Financial assets at fair value through profit or loss
 - Available-for-sale financial assets
 - Investments in equity instruments without fair value
 - Loans and receivables
 - Held-to-maturity investments

The categories named in IAS 39

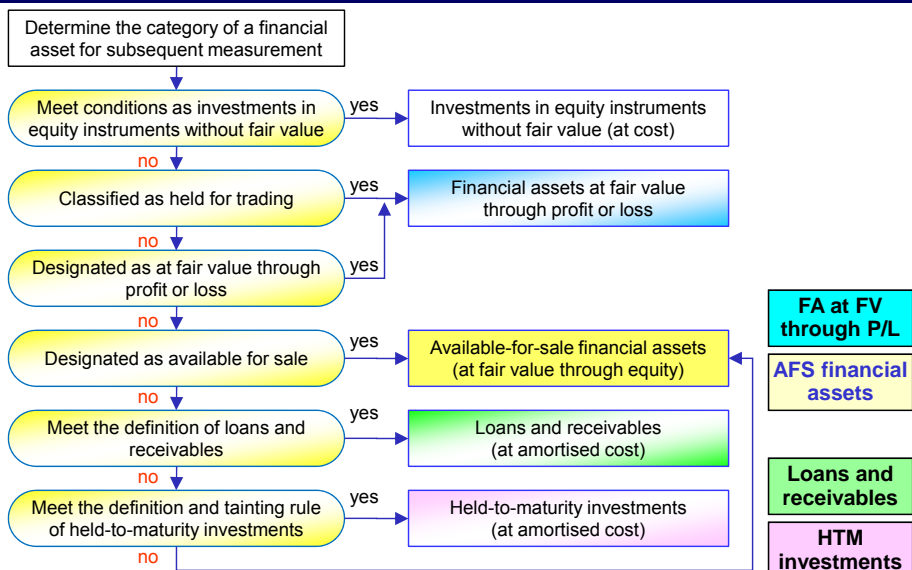
FA at FV through P/L

AFS financial assets

Loans and receivables

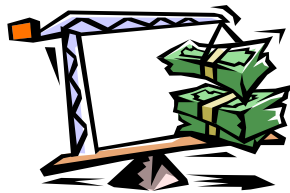
HTM investments

Classification and Definitions



Classification and Definitions

- Even the requirements of IAS 39 imply that the category of a financial asset determines the subsequent measurement of the financial asset,
 - an entity can choose to use all or some of the categories.
- Implicitly from the definitions and reclassification requirements in IAS 39,
 - an entity has to determine the category of its financial asset at initial recognition.



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

Classification and Definitions

Determine the category of a financial asset for subsequent measurement

Meet conditions as investments in equity instruments without fair value

3 conditions to qualify as investments in equity instruments without fair value:

1. The asset is an equity instrument
2. No active market for the asset
3. Fair value of the asset cannot be reliably measured

- No financial assets can be measured at cost
 - unless the financial asset is an investment in equity instrument that meets all the above three conditions.
- The category of “investments in equity instruments”
 - Also includes the derivatives that are linked to and must be settled by delivery of such unquoted equity instruments
 - Such derivatives are also measured at cost.

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

Classification and Definitions

Fair Value Measurement Consideration

- Fair value is defined in IAS 39 and the same definition is used for both initial measurement and subsequent measurement.
- In determining whether there is a fair value for a financial instrument for subsequent measurement (whether it can be reliably measured),
 - IAS 39 implies a hierarchy for the determination of fair value that an entity is required to apply.
 - The hierarchy refers to
 1. the existence of active market, and
 2. no existence of active market.

Active Market

No Active Market

FA at FV through P/L

AFS financial assets

Loans and receivables

HTM investments

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Classification and Definitions

Fair Value Measurement Consideration

Active Market

- The best evidence of fair value
 - is quoted prices in an active market.
- Quote is in an active market
 - If quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

FA at FV through P/L

AFS financial assets

Loans and receivables

HTM investments

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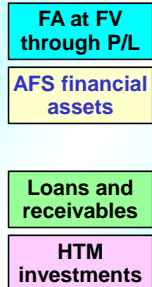
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Classification and Definitions

Fair Value Measurement Consideration

Active Market

- Different kinds of quoted market price would be used as reference in the following manner:
 - For a financial asset held or a financial liability to be issued
 - is usually the current bid price.
 - For a financial asset to be acquired or a financial liability held
 - is usually the asking price.
 - When an entity has assets and liabilities with offsetting market risks,
 - it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate.
 - When current bid and asking prices are unavailable,
 - the price of the most recent transaction provides evidence of the current fair value



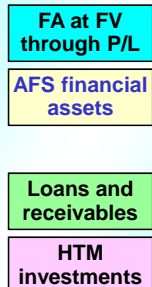
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Classification and Definitions

Fair Value Measurement Consideration

No Active Market

- If there is no quotation of an active market for a financial instrument or part of the consideration given or received in the transaction is for something other than the financial instrument,
 - the fair value of the financial instrument is estimated using a valuation technique.



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Classification and Definitions

Fair Value Measurement Consideration

No Active Market

- Valuation techniques for financial instruments specified in IAS 39 include:
 - using recent arm's length market transactions between knowledgeable, willing parties, if available,
 - reference to the current fair value of another instrument that is substantially the same,
 - discounted cash flow analysis and
 - option pricing models.
- If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions,
 - the entity uses that technique.

FA at FV through P/L

AFS financial assets

Loans and receivables

HTM investments

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Classification and Definitions

Case



Accounting policy 2007

- The fair values of quoted investments in active markets are based on current bid prices.
- If the market for a financial asset is not active (and for unlisted securities), the Group establishes fair value by using valuation techniques.
- These include the use of
 - recent arm's length transactions,
 - discounted cash flow analysis,
 - option pricing models and
 - other valuation techniques commonly used by market participants.

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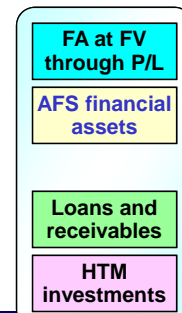
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Classification and Definitions

Fair Value Measurement Consideration

No Active Market

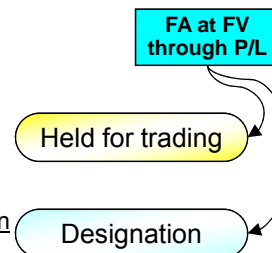
- When an investment in equity instrument can be classified as “investment in equity instrument without fair value”,
 - it implies that, after the application the hierarchy for the determination of fair value, the entity is still unable to reliably measure the equity instrument.
- IAS 39 further explains that the fair value of investments in equity instruments that do not have a quoted market price in an active market is still reliably measurable if
 1. The variability in the range of reasonable fair value estimates is not significant for that instrument or
 2. The probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.



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Classification and Definitions

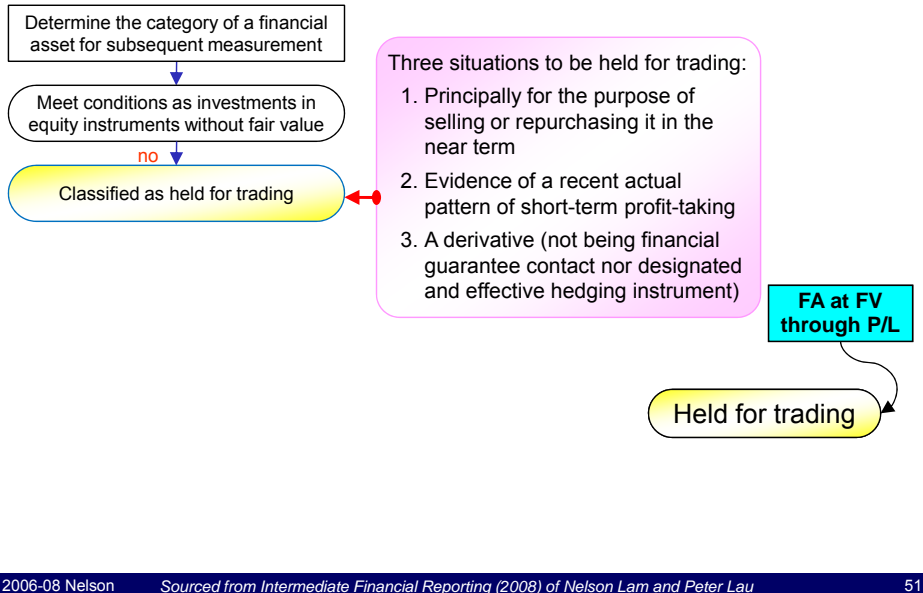
- The definition of the category of “financial assets at fair value through profit or loss” is comparatively complicated.
 - Firstly, IAS 39 formally describes this classification as “financial asset or financial liability at fair value through profit or loss” and
 - implies that the same definition of classification can be applied to both financial assets and financial liabilities.
 - Secondly, the definition of this classification requires that
 - certain financial instruments “held for trading” must be classified as “fair value through profit or loss”, and
 - an entity is allowed to choose to designate certain other financial instruments as “fair value through profit or loss” at their initial recognition.



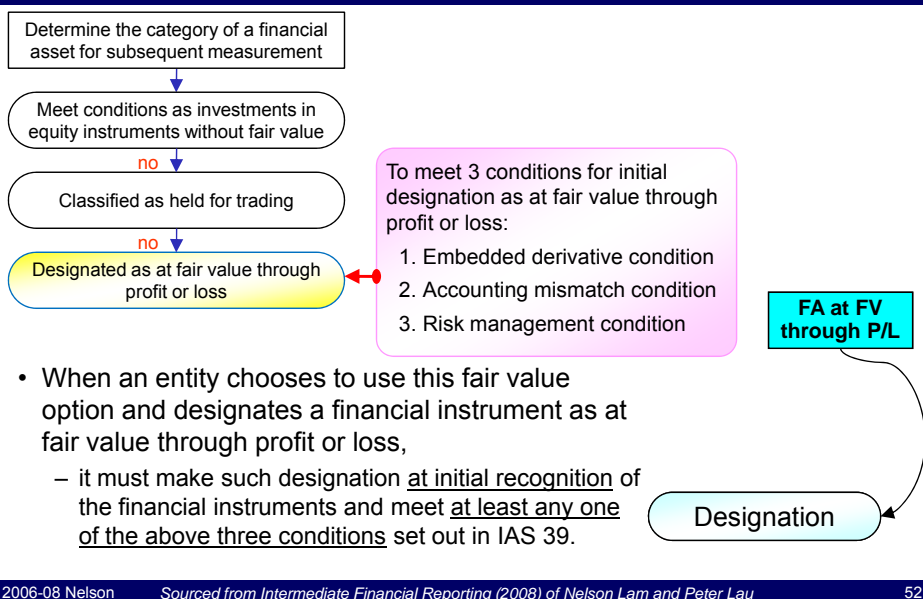
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Classification and Definitions



Classification and Definitions



Classification and Definitions

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



Classification and Definitions

Paragraph 11A of IAS 39

- if a contract contains one or more embedded derivatives,
 - an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:
 - a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or
 - b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

1. Embedded Derivative Condition

Classification and Definitions

- It eliminates or significantly reduces
 - a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from
 - measuring assets or liabilities or
 - recognising the gains and losses on them on different bases

**2. Eliminates
Inconsistency**



Classification and Definitions

Example

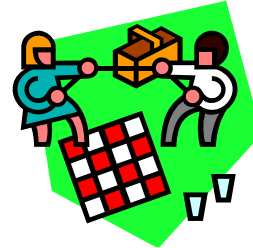
- Entity A has a financial asset, say a portfolio of fixed income securities, would be classified as AFS financial asset
 - changes in fair value recognised in equity
- The portfolio is related to a financial liability, say a fixed rate bond, which is measured at amortised cost

**2. Eliminates
Inconsistency**

- In such circumstances, an entity may conclude that its financial statements would provide more relevant information
 - if both the asset and the liability were classified as at fair value through profit or loss

Classification and Definitions

- A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis,
 - in accordance with a documented risk management or investment strategy, and
 - information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24)
 - e.g. the entity's board of directors and chief executive officer.



3. Managed on Fair Value Basis

Classification and Definitions

Example

- The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value.
- IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*
 - allow such investments to be excluded from their scope provided they are measured at fair value through profit or loss.

3. Managed on Fair Value Basis

- An entity may apply the same accounting policy to other investments managed on a total return basis
 - but over which its influence is insufficient for them to be within the scope of IAS 28 or IAS 31.

Classification and Definitions

Case

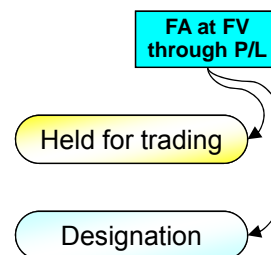


Fair Value Through Profit and Loss (Annual Report 2006)

- 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.

Classification and Definitions

- When an entity has chosen to apply fair value option to a financial asset,
 - the definition of the fair value option additionally imposes strict requirements on measurement and disclosure.
- The definition of financial asset at fair value through profit or loss specifically requires that
 - an entity is not allowed to designate any investments in equity instruments without fair value as at fair value through profit or loss.
- It also describes that requirements for determining a reliable measure of the fair value of a financial asset, apply equally to all items that are measured at fair value, whether by designation or otherwise, or whose fair value is disclosed.
- Additional disclosure is also found in IFRS 7.



Classification and Definitions

Case

China Life Insurance Company Limited



- Accounting report 2006

Financial assets at fair value through income

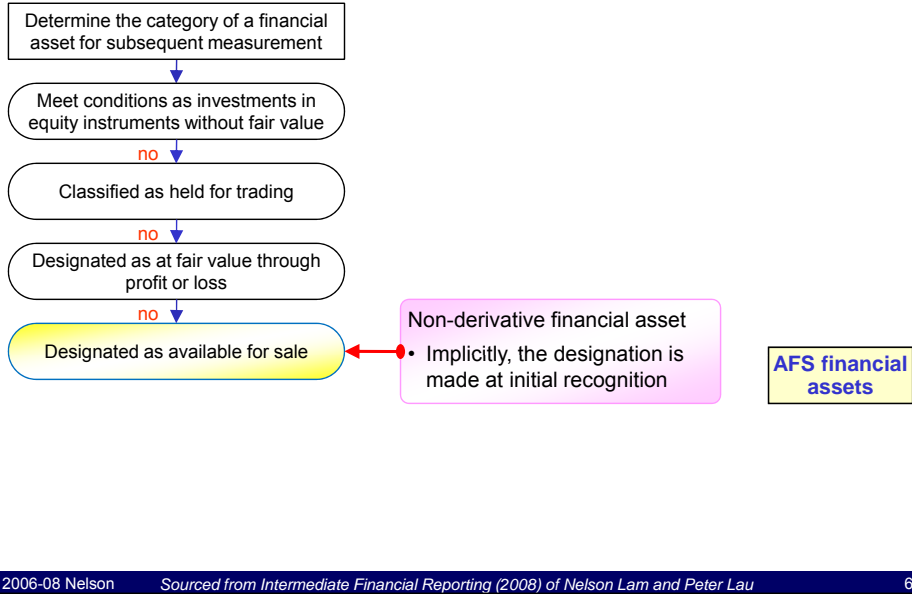
- This category has two sub-categories:
 - financial assets held for trading and
 - those designated at fair value through income at inception.
- A financial asset is classified as held for trading at inception
 - if acquired principally for the purpose of selling in the short term or
 - if it forms part of a portfolio of financial assets in which there is evidence of short term profit-taking.
- Any other additional financial assets may be designated at fair value through income at inception by the Group.
 - The Group presently has no financial assets designated at fair value through income at inception.

Classification and Definitions

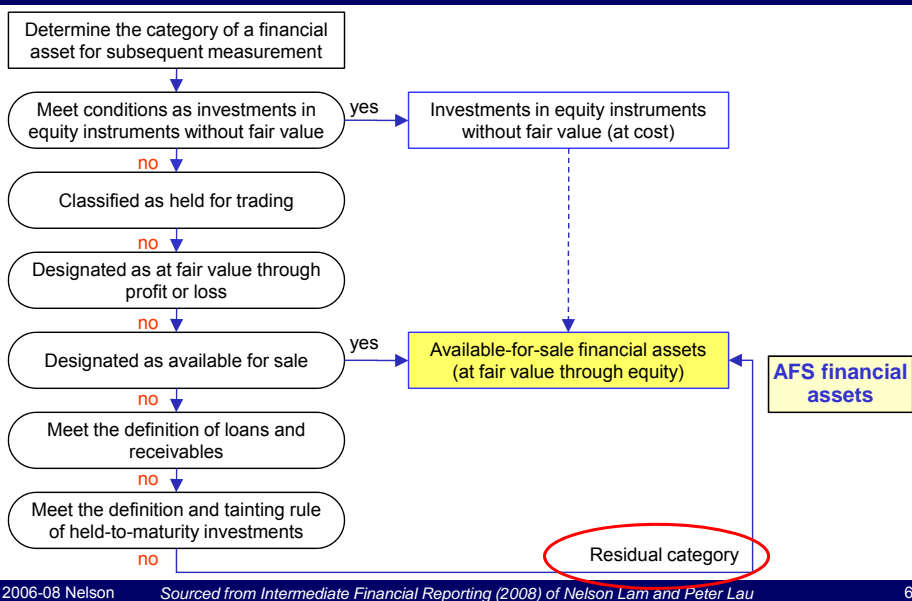
- Available-for-sale financial assets are those non-derivative financial assets that
 - are designated as available for sale or
 - are not classified as
 1. Loans and receivables,
 2. Held-to-maturity investments or
 3. Financial assets at fair value through profit or loss.

AFS financial assets

Classification and Definitions



Classification and Definitions

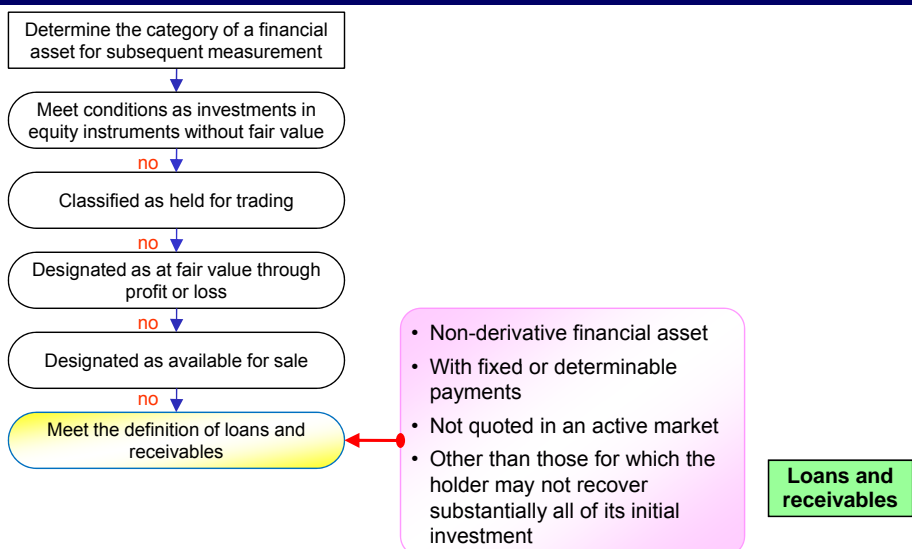


Classification and Definitions

- Theoretically, investments in equity instruments without fair value are also available-for-sale financial assets, because
 - the definition of financial assets at fair value through profit or loss excludes investments in equity instruments,
 - as equity instruments do not have fixed maturity and fixed or determinable payment, they are not classified as loans and receivables and held-to-maturity investments
- In consequence, investments in equity instruments without fair value should also
 - be the “residual” investments and
 - be regarded as available-for-sale financial assets.

AFS financial assets

Classification and Definitions



Classification and Definitions

- Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:
 1. those that the entity intends to sell immediately or in the near term, which shall be classified as “held for trading”, and those that the entity upon initial recognition designates as at “fair value through profit or loss”;
 2. those that the entity upon initial recognition designates as “available for sale”; or
 3. those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as “available for sale”.

An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.

Loans and receivables

Classification and Definitions

Example

Classification of Investment in Preference Share

Can an equity instrument, such as a preference share, with fixed or determinable payments be classified within loans and receivables by the holder?

Yes.

- If a non-derivative equity instrument would be recorded as a liability by the issuer, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holder, provided the definition is otherwise met.
- IAS 32 provides guidance about the classification of a financial instrument as a liability or as equity from the perspective of the issuer of a financial instrument.
- If an instrument meets the definition of an equity instrument under IAS 32, it cannot be classified within loans and receivables by the holder.

Classification and Definitions

Case

China Life Insurance Company Limited

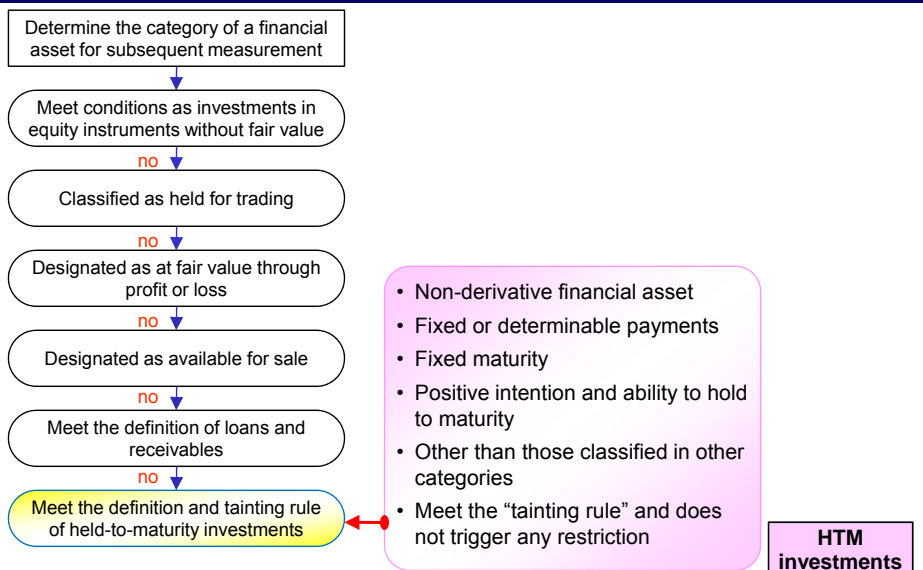


• Accounting report 2006

Financial assets – Classification

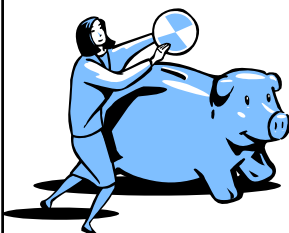
- The Group classifies its investments in securities into the following categories:
 - held-to-maturity securities,
 - financial assets at fair value through income and
 - available-for-sale securities.
- The classification depends on the purpose for which the investments were acquired. Management determines the classification of its investments at initial recognition.
- Financial assets other than investment in securities are loans and receivables
 - which are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than those that the Group intends to sell in the short term or available for sale.
 - Loans and receivables mainly comprise term deposits, policy loans, securities purchased under agreements to resell and accrued investment income as presented separately in the balance sheet.

Classification and Definitions



Classification and Definitions

- Held-to-maturity investments are defined as:
 - non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than:
 1. those that the entity upon initial recognition designates as at “fair value through profit or loss”;
 2. those that the entity designates as “available for sale”; and
 3. those that meet the definition of “loans and receivables”.



HTM
investments

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Classification and Definitions

Meeting the Definition of Loans and Receivables

- While both loans and receivables and held-to-maturity investments are non-derivative financial assets with fixed or determinable payments, their differences are that:
 - Fixed maturity is required for held-to-maturity investments but not required for loans and receivable.
 - Positive intention and ability to hold to maturity investments is required for held-to maturity investments but not required for loans and receivables.
 - Loans and receivables cannot be a financial asset for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration.
 - Loans and receivables must not be quoted in an active market but such requirement is not imposed on held-to-maturity investments.
 - Loans and receivables are not subject to tainting rule, which is applied to held-to-maturity.

HTM
investments

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Classification and Definitions

Case



• Accounting report 2006

Held-to-maturity securities

- Dated debt securities that the group and/or the company have
 - o the positive ability and
 - o intention to hold to maturityare classified as held-to-maturity securities.
- Held-to-maturity securities are stated in the balance sheet at amortised cost less impairment losses

Classification and Definitions

Example

Bond with index-linked interest

- Entity A buys a bond with a fixed payment at maturity and a fixed maturity date.
- The bond's interest payments are indexed to the price of a commodity or equity.
- Entity A has positive intention and ability to hold the bond to maturity.
- Can Entity A classify the bond as a HTM investment?

Yes.

- However, 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.

Classification and Definitions

Tainting Rule

- 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)
 - other than sales or reclassifications that:
 - i. are so close to maturity or the financial asset's call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
 - ii. occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or
 - iii. 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.

HTM
investments

Classification and Definitions

Example

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.

Classification and Definitions

Example

Downgrade of Credit Rating

Would a sale of a held-to-maturity investment following a downgrade of the issuer's credit rating by a rating agency raise a question about the entity's intention to hold other investments to maturity?

Not necessarily

- A downgrade is likely to indicate a decline in the issuer's creditworthiness.
- IAS 39 specifies that a sale due to a significant deterioration in the issuer's creditworthiness could satisfy the condition in IAS 39 and therefore not raise a question about the entity's intention to hold other investments to maturity.
- However, the deterioration in creditworthiness must be significant judged by reference to the credit rating at initial recognition.
- Also, the rating downgrade must not have been reasonably anticipated when the entity classified the investment as held to maturity in order to meet the condition in IAS 39.

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Classification and Definitions

Example

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.

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Classification and Definitions

Example

Different entities in a group

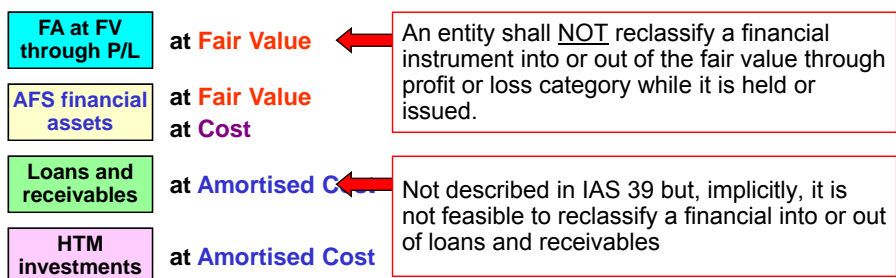
Can an entity apply the **Tainting Rule** separately to HTM investments held by different entities in a consolidated group, for example, if those group entities are in different countries with different legal or economic environments?

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.

Classification and Reclassification

Reclassification



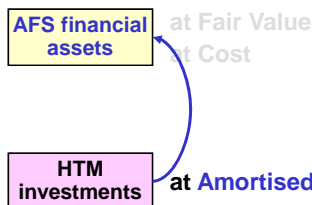
Classification and Reclassification

Summary		Reclassified to		
		HTM investments	AFS financial assets at cost	AFS financial assets at fair value
Reclassified from	HTM investments	N/A	<ul style="list-style-type: none"> Impossible as debt cannot be carried at cost 	<ul style="list-style-type: none"> Change in intention or ability, or Tainting rule triggered
	AFS financial assets at cost	<ul style="list-style-type: none"> Impossible as equity cannot be held to maturity 	N/A	<ul style="list-style-type: none"> Reliable measure of fair value is available
	AFS financial assets at fair value	<ul style="list-style-type: none"> Change in intention or ability or Tainting rule expired 	<ul style="list-style-type: none"> In rare case, fair value is no longer available 	N/A

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Classification and Reclassification

Reclassification



A change in intention or ability

- HTM investments shall be
 - reclassified as AFS financial assets
 - re-measured at fair value, and
 - the difference between its carrying amount and fair value shall be recognised directly in equity

Tainting rule triggered

- Any remaining HTM investments shall be reclassified as AFS financial assets.
- On such reclassification, the difference between their carrying amount and fair value shall be recognised directly in equity

Classification and Reclassification

Reclassification

AFS financial assets at Fair Value at Cost

If a reliable measure becomes available on fair value

- the asset shall be re-measured at fair value, and
- the difference between its carrying amount and fair value shall be accounted for depending the classification of such asset as
 - FA at FV through P/L, or
 - AFS financial assets

Classification and Reclassification

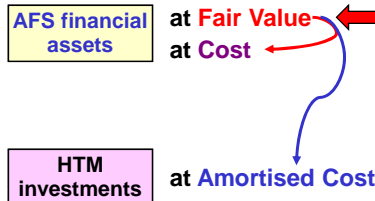
Reclassification

AFS financial assets at Fair Value at Cost

HTM investments at Amortised Cost

- In case of
 - a change in intention or ability
 - in the rare circumstance, a reliable measure of fair value is no longer available, or
 - tainting rule expires
- Then, it becomes appropriate to carry a financial asset at cost or amortised cost rather than at fair value

Classification and Reclassification

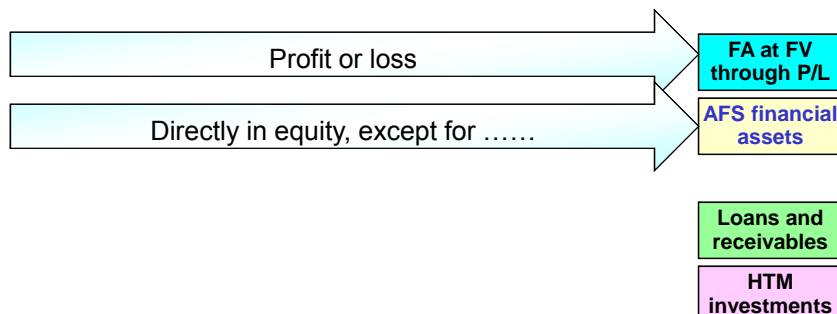


Reclassification

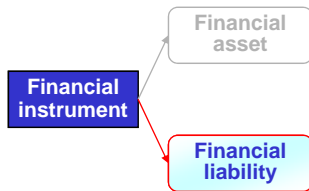
- The fair value carrying amount of the asset on that date becomes its new cost or amortised cost, as applicable
- Any previous gain or loss on that asset that has been recognised directly in equity shall be accounted for as follows:
 - In the case of a financial asset with a fixed maturity
 - the gain or loss shall be amortised to P/L over the remaining life of the HTM investment using the effective interest method.
 - In the case of a financial asset that does not have a fixed maturity
 - the gain or loss shall remain in equity until the financial asset is sold or otherwise disposed of, when it shall be recognised in P/L.

Classification and Reclassification

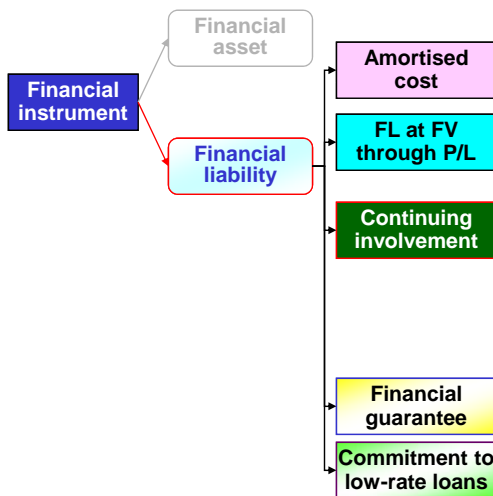
- The classification of financial assets determines
 - not only the measurement of financial assets
 - but also the recognition of changes in fair value of the financial assets and the gain or loss arising from such changes.



Classification of Financial Liability



Classification of Financial Liability



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.

Classification of Financial Liability

Case



• 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.

Classification of Financial Liability

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
 - 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)
- 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

Classification of Financial Liability

FL at FV
through P/L

- Financial liabilities held for trading include:
 - a) derivative liabilities that are not accounted for as hedging instruments;
 - b) obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own);
 - c) financial liabilities that are incurred with an intention to repurchase them in the near term (e.g. a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
 - d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.
- The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

Classification of Financial Liability

Financial
guarantee

Commitment to
low-rate loans

- Financial guarantee contract is defined in IAS 39 as a contract that:
 - requires the issuer 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 original or modified terms of a debt instrument.

- Financial guarantee contracts may have various legal forms, such as
 - a guarantee
 - some types of letter of credit
 - a credit default contract or
 - an insurance contract



Classification of Financial Liability

Financial guarantee

- 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.

Asserted Explicitly

Used Insurance Accounting

Classification of Financial Liability

Financial guarantee

Assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer’s

- communications with customers and regulators,
- contracts,
- business documentation and
- financial statements.

Asserted Explicitly

Used Insurance Accounting

- KPMG (FRU Issue 28, Jan. 2006):
 - This election applies to previously existing contracts as well as to similar contracts that an entity may enter into in the future.
- Ernst & Young (Sep. 2005):
 - The amendment applies to all existing contracts and any new contracts issued by an entity.

Classification of Financial Liability

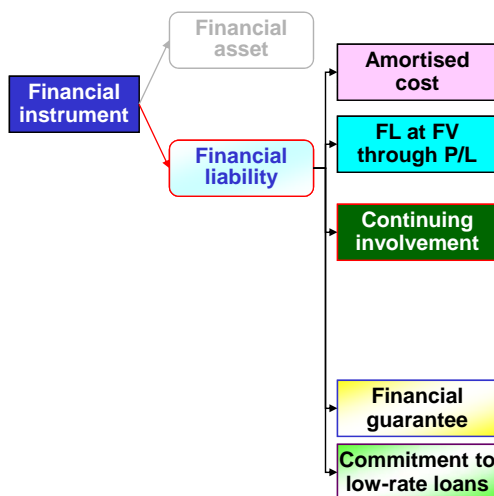
Case

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.

Classification of Financial Liability



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

IAS 32, IAS 39, IFRS 4 and IFRS 7 (Part 1)

September 2008

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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 (Part 1)

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Nelson Lam 林智遠
nelson@nelsoncpa.com.hk
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