IAS 32, IAS 39, IFRS 4 and IFRS 7
(Part 2)

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Main Coverage

IAS 32

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

IFRS 7

- Disclosure requirements

IFRS 4

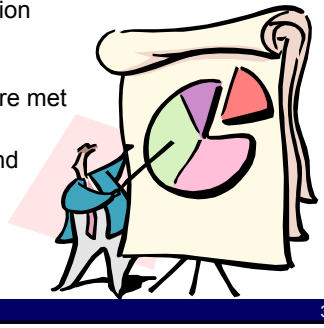
- Limited improvements
- Disclosure requirements

IAS 39

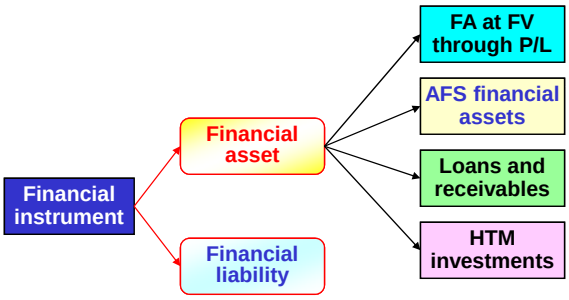
- Classification of financial instruments
- Recognition and derecognition of financial instruments
- Measurement of financial instruments
- Derivatives and embedded derivatives
- Hedging and hedge accounting

Today's Agenda

Measurement	• Except for strict conditions are fulfilled, all financial assets are measured at fair value
Reclassification	• Reclassification of financial asset between category only allowed on specific situation
Impairment	• Impairment loss on financial asset is recognised on specific situation
Derecognition	• Financial asset can only be derecognised when test(s) are met
Derivatives	• Accounting for derivatives and embedded derivatives



Classification and Definitions

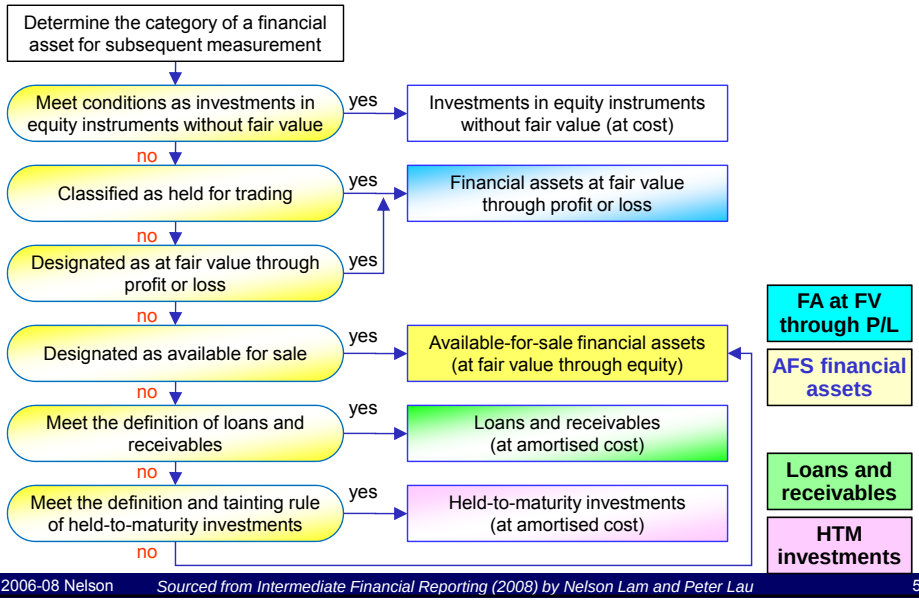


1. Financial assets at fair value through profit or loss
2. Available-for-sale financial assets
3. Loans and receivables
4. Held-to-maturity investments

- 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 of Financial Asset



Today's Agenda

Measurement

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

Subsequent Measurement of F.A.

- At initial recognition,
  - Financial asset is normally using trade date accounting at fair value plus transaction cost, except for financial asset at fair value through profit or loss.
  - Financial asset at fair value through profit or loss is initially recognised at fair value only.
- After initial recognition, an entity is required to measure financial assets, including derivatives that are assets, at their fair values, except for the following financial assets:
  - Investments in equity instruments without fair value
  - Loans and receivables
  - Held-to-maturity investments

at fair value

at cost

at amortised cost

at amortised cost

Subsequent Measurement of F.A.

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

Loans and receivables

HTM investments

Subsequent Measurement of F.A.

- An entity is required to use the effective interest method and effective interest rate to subsequently measure loans and receivables and held-to-maturity investments at amortised cost.
  - The effective interest method is a method:
    - of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and
    - of allocating the interest income or interest expense over the relevant period.
  - The effective interest rate is the rate that exactly discounts
    - estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period
    - to the net carrying amount of the financial asset or financial liability.

Loans and receivables

HTM investments

Subsequent Measurement of F.A.

Example

- On 2 January 2007, Knut Investments Limited purchased a new 5-year debt instrument at its fair value plus transaction costs at $8,000.
- The principal amount of the instrument was $10,000 and the instrument carried fixed interest of 4.75% that would be paid annually.
- The issuer of the instrument had an option to prepay the instrument and that no penalty would be charged for prepayment.
- At inception, Knut expected the issuer not to exercise this option and there is no incurred credit loss.
- Explain and calculate the effective interest rate of the 5-year debt instrument for Knut.

Subsequent Measurement of F.A.

Example

- The effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the instrument to the net carrying amount of the instrument.
- In Knut's case, the estimated future cash receipts are the annual interest receipts ($10,000 × 4.75% = $475 per year) and the final principal receipts ($10,000) and the expected life of the instrument is 5 years, the effective interest rate can be found by using the following equation:

$$\$8{,}000 = \frac{\$475}{(1+r)^1} + \frac{\$475}{(1+r)^2} + \frac{\$475}{(1+r)^3} + \frac{\$475}{(1+r)^4} + \frac{\$475 + \$10{,}000}{(1+r)^5}$$

- The effective interest rate, *r*, should be 10.03%. In other words, in order to allocate interest receipts ($475) and the initial discount ($10,000 – $8,000 = $2,000) over the term of the debt instrument at a constant rate on the carrying amount, the effective interest must be accrued at the rate of 10.03% annually.

 Sourced from Intermediate Financial Reporting (2008) by Nelson Lam and Peter Lau

Subsequent Measurement of F.A.

- By using the effective interest method and effective interest rate,
  - an entity can derive the amortised cost on its financial assets classified as loans and receivables and held-to-maturity investments.

Loans and receivables

HTM investments

Subsequent Measurement of F.A

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

Subsequent Measurement of F.A

Case

Hang Seng Bank *(2004 Annual Report)*

Loan fee income and costs

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

恒生銀行 HANG SENG BANK

Subsequent Measurement of F.A.

Example

- Based on the previous example, Knut Investments Limited purchases a new 5-year debt instrument at its fair value plus transaction costs at $8,000 on 2 January 2007.
- The principal amount of the instrument is $10,000 and the instrument carried fixed interest of 4.75% that is paid annually.
- The effective interest rate as estimated is 10.03%.
- Explain and calculate the amortised cost and interest income of the 5-year debt instrument for Knut in each reporting period.

Subsequent Measurement of F.A.

Example

- While the initial amount of the 5-year debt instrument is $8,000 and its principal (or maturity amount) is $10,000, Knut has purchased the instrument at a discount.
- Since the effective interest is accrued at 10.03% annually, the interest income for 2007 will be $802 ($8,000 × 10.03%) and the amortisation of the discount will be $327 ($802 – $ 475).
- In consequence, the amortised cost of the 5-year debt instrument at the end of 2007 will be:

The amount at which financial asset is measured at initial recognition	$8,000
– Minus principal repayments	0
– Plus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount	327
– Minus any reduction for impairment or uncollectibility	0
Amortised cost at the end of 2007	*$8,327*

Subsequent Measurement of F.A.

Example

- The amortised cost, interest income and cash flows of the debt instrument in each reporting period can be summarised as follows:

Year	Amortised cost at the beginning of the year	Interest income	Cash inflows	Amortised cost at the end of the year
2007	$ 8,000	$ 802	$ 475	$ 8,327
2008	8,327	836	475	8,688
2009	8,688	871	475	9,084
2010	9,084	911	475	9,520
2011	9,520	955	10,475	0

- For example, in 2007, the following journal entries should be recognised by Knut:

Dr	Loans and receivables	$8,000	
Cr	Cash		$8,000

Being the initial recognition of the 5-year debt instrument.

Subsequent Measurement of F.A.

Example

Dr	Loans and receivables	$802	
Cr	Profit or loss		$802

To recognise the interest income using the effective interest rate.

Dr	Cash	$475	
Cr	Loans and receivables		$475

Being the cash received from the 5-year debt instrument at the end of 2007.

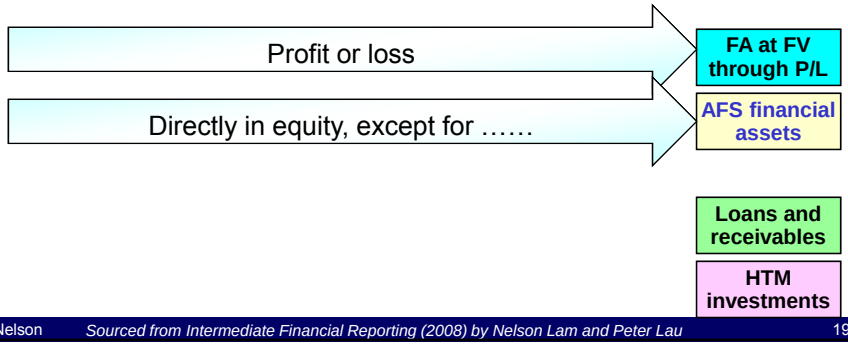
- The last two journal entries above may be combined and recognised as follows:

Dr	Loans and receivables	$327	
	Cash	$475	
Cr	Profit or loss		$802

To recognise the interest income using the effective interest rate and the cash received from the 5-year debt instrument at the end of 2007.

Subsequent Measurement of F.A.

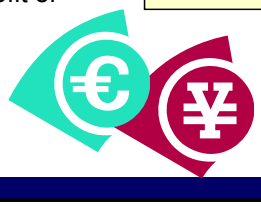
- The classification of financial assets determines
  - not only the measurement of financial assets
  - but also the recognition of changes in fair value of the financial assets and the gain or loss arising from such changes.



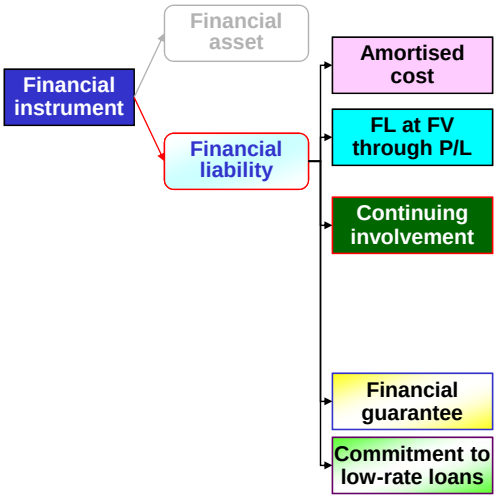
Subsequent Measurement of F.A.

- An entity is required to recognise a gain or loss on an available-for-sale financial asset directly in equity (or in other comprehensive income) until the financial asset is derecognised,
  - except for:
    - impairment losses and
    - foreign exchange gains and losses.
- At the time when an available-for-sale financial asset is derecognised, the cumulative gain or loss previously recognised in equity (or in other comprehensive income) is recognised in (or reclassified from equity to) profit or loss.

AFS financial assets



Subsequent Measurement of F.L.



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

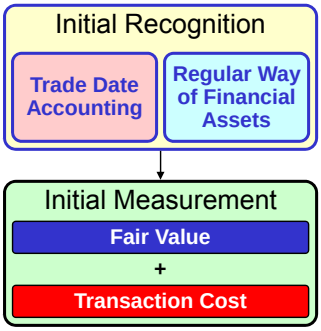
d) Commitments to provide a loan at a below-market interest rate.

Subsequent Measurement of F.L.

Financial guarantee

Commitment to low-rate loans

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



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

Subsequent Measurement of F.L.

Financial guarantee

Commitment to low-rate loans

After initial recognition,

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

Subsequent Measurement of F.L.

Financial guarantee

Asserted Explicitly

Used Insurance Accounting

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

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

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

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

Subsequent Measurement of F.L.

Case

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

- Accounting report 2006

Changes in accounting policies – Financial Guarantee Contracts

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

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

Subsequent Measurement of F.L.

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

Dr	Cash/Assets
Cr	Payables

Dr	Profit & loss
Cr	Payables

Subsequent Measurement of F.L.

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

Subsequent Measurement of F.L.

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.

Today's Agenda

Reclassification

- Reclassification between category only allowed on specific situation

Reclassifications between Category

Reclassification

FA at FV through P/L	**at Fair Value**	An entity shall NOT reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.
AFS financial assets	**at Fair Value** **at Cost**	
Loans and receivables	**at Amortised Cost**	Not described in IAS 39 but, implicitly, it is not feasible to reclassify a financial into or out of loans and receivables
HTM investments	**at Amortised Cost**	

Reclassifications between Category

Summary

		Reclassified to		
		HTM investments	AFS financial assets at cost	AFS financial assets at fair value
Reclassified from	HTM investments	N/A	• Impossible as debt cannot be carried at cost	• Change in intention or ability, or • Tainting rule triggered
	AFS financial assets at cost	• Impossible as equity cannot be held to maturity	N/A	• Reliable measure of fair value is available
	AFS financial assets at fair value	• Change in intention or ability or • Tainting rule expired	• In rare case, fair value is no longer available	N/A

Reclassifications between Category

AFS financial assets at Fair Value / at Cost

HTM investments at Amortised Cost

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

Reclassifications between Category

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

Reclassifications between Category

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

Reclassifications between Category

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:
  a) 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.
  b) 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.

AFS financial assets — at **Fair Value** / at **Cost**

HTM investments — at **Amortised Cost**

Today's Agenda

Impairment

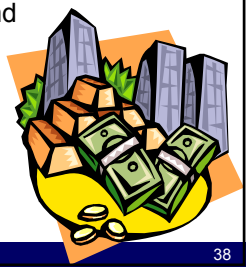
- Impairment loss is recognised on specific situation

Impairment & Uncollectibility of F.A.

- Before IAS 39,
  - there was no IAS or IFRS to mandate an assessment of the impairment or the collectability of financial assets.
- Even nearly all entities would assess the recoverability of financial assets, in particular trade or other receivables, and make different amounts of bad debt, provision for bad debt or provision for doubtful debt,
  - there were no consistent practices.

Impairment & Uncollectibility of F.A.

- IAS 39 introduces the compulsory and consistent requirements in assessing the impairment and collectability of financial assets and requires that all financial assets, except for those financial assets measured at fair value through profit or loss, are subject to review for impairment.
- In accordance with the IAS 39, an entity is required to adopt the following two-step approach in recognising the impairment loss:
  - Assessment of objective evidence of impairment, and
  - Measurement and recognition of impairment loss.



Impairment & Uncollectibility of F.A.

Investments in Equity Instruments without Fair Value

- For investment in equity instrument without fair value (including a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument), if there is objective evidence that an impairment loss has been incurred on such investment,
  - the amount of the impairment loss is measured as the difference between:
    - the carrying amount of the financial asset, and
    - the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.
- NO reversal of impairment loss on investments in equity instruments without fair value would be allowed.

Impairment & Uncollectibility of F.A.

Loans and receivables & held-to-maturity investments

- IAS 39 provides specific guidance in assessing the objective evidence of their impairment and in measuring and recognising the impairment loss.
  - The process for estimating impairment considers all credit exposures, not only those of low credit quality;
  - The process in assessing the objective evidence and the process in measuring the impairment loss are illustrated separately below, they can be performed simultaneously.

Impairment & Uncollectibility of F.A.

Loans and receivables & held-to-maturity investments

- **Two-Stage Assessment of Objective Evidence**
  - Before an impairment loss is measured and recognised, an entity is required to assess whether objective evidence of impairment exists for loans and receivables and held-to-maturity investments using a two-stage assessment approach as follows:
    1. **First stage (individual assessment)** – an entity is required to firstly assesses whether objective evidence of impairment exists
       - individually for the financial assets that are individually significant, and
       - individually or collectively for the financial assets that are not individually significant.
    2. **Second stage (collective assessment)** – 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.

Impairment & Uncollectibility of F.A.

Case

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

- Accounting report 2006

Impairment of financial assets

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

Individual Assessment

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

Collective Assessment

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

Impairment & Uncollectibility of F.A.

Loans and receivables & held-to-maturity investments

- If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the 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).

Impairment & Uncollectibility of F.A.

Loans and receivables & held-to-maturity investments

- The amount of the impairment loss on loans and receivables or held-to-maturity investments is recognised in profit or loss while the carrying amount of the impaired asset is reduced either:
  - directly in the asset or
  - through use of an allowance account.

Impairment & Uncollectibility of F.A.

Example

Amortised Cost on Low Interest Loan

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

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

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

Impairment & Uncollectibility of F.A.

Example

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

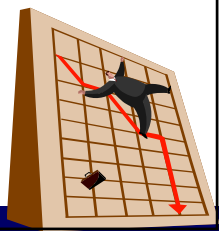
Carrying amount (per the balance as at 31.12.2006)	$ 48,167
Present Value of estimated future cash flows discounted at original effective interest rate as at 2.1.2006	44,500
Impairment loss	$ 3,667

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

Impairment & Uncollectibility of F.A.

Loans and receivables & held-to-maturity investments

- An entity is required to reverse the previously recognised impairment loss on loans and receivables or held-to-maturity investments either directly or by adjusting an allowance account if, in a subsequent period, the following two conditions are met:
  - the amount of the impairment loss decreases and
  - the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating).
- The amount of the reversal is recognised in profit or loss but it must not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed.



Impairment & Uncollectibility of F.A.

Available-for-Sale Financial Assets

- For available-for-sale financial asset carried at fair value, an entity recognises the impairment loss on it only when:
  - a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and
  - there is objective evidence that the asset is impaired.
- In recognising the impairment loss on an available-for-sale financial asset, the entity
  - removes the cumulative loss that had been recognised directly in equity from equity and
  - recognises the loss in profit or loss even though t financial asset has not been derecognised.

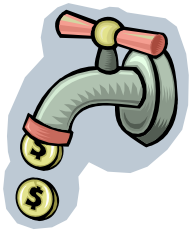
Impairment & Uncollectibility of F.A.

Available-for-Sale Financial Assets

- The amount of the cumulative loss that is removed from equity and recognised in profit or loss is the difference between:
  - the acquisition cost (net of any principal repayment and amortisation) and
  - the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss.

Impairment & Uncollectibility of F.A.

Available-for-Sale Financial Assets



- Impairment losses on available-for-sale equity instruments
  - cannot be reversed through profit or loss (IAS 39.69), i.e. any subsequent increase in fair value is recognised in equity.
- Reversal of the impairment loss on available-for-sale debt instrument through profit or loss is instead allowed.
  - After an impairment loss on available-for-sale debt instrument is recognised in profit or loss, if (1) the fair value of such instrument increases and (2) the increase can be objectively related to an event occurring after the recognition of impairment loss through profit or loss,
    - an entity reverses the impairment loss, with the amount of the reversal recognised in profit or loss.

Impairment & Uncollectibility of F.A.

Example

Impairment at Initial Recognition

- Entity A lends $2,000 to Customer B
- Based on past experience, Entity A expects that 1% of the principal amount of loans given will not be collectable.
- Can Entity A recognise an immediate impairment loss of $20?

No.

- IAS 39 requires financial asset to be initially measured at fair value.
- For a loan asset, the fair value is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges).
- In addition, IAS 39 further requires that an impairment loss is recognised only if there is objective evidence of impairment as a result of a past event that occurred after initial recognition.
- Thus, it is inconsistent with IAS 39 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.

Impairment & Uncollectibility of F.A.

Example

Impairment Based on Ageing Analysis

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

Not necessarily.

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

Impairment & Uncollectibility of F.A.

Example

Impairment on Portfolio Basis

- If one loan in Entity A is impaired but the fair value of another loan in Entity A is above its amortised cost.
- Does IAS 39 allow non-recognition of the impairment of the first loan?

No.

- If an entity knows that an individual financial asset carried at amortised cost is impaired, IAS 39 requires that the impairment of that asset should be recognised.
- IAS 39 states: "the amount of the 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".
- Measurement of impairment on a portfolio basis under IAS 39 may be applied to groups of small balance items and to financial assets that are individually assessed and found not to be impaired when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

Impairment & Uncollectibility of F.A.

Example

Aggregate Fair Value Less Than Carrying Amount

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

Not necessarily.

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

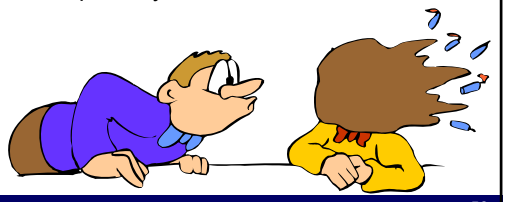
Today's Agenda

Derecognition

- Financial asset can only be derecognised when test(s) are met

Derecognition of Financial Asset

- Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.
  - Derecognition of an asset or a liability is originally a simple concept.
- Practically, it is not that simple for financial assets and financial liabilities.
  - Even a financial asset or a financial liability had been transferred, either or both the risk and reward and control of the financial asset or the obligation of the financial liability might have not been transferred.
  - IAS 39 sets out detailed derecognition criteria and requirements on financial assets and financial liabilities separately.



Sourced from Intermediate Financial Reporting (2008) by Nelson Lam and Peter Lau

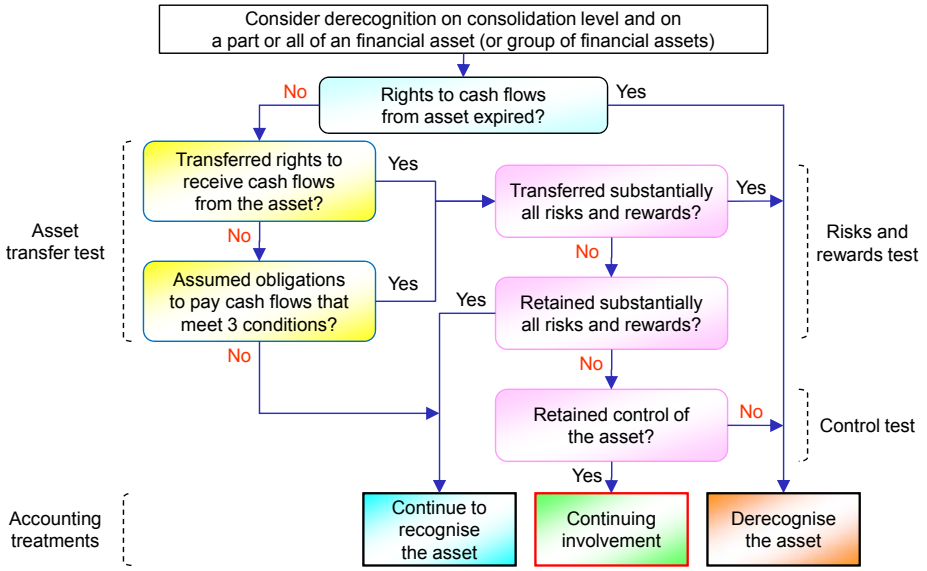
Derecognition of Financial Asset

- The general derecognition criteria in accordance with IAS 39 require an entity to derecognise a financial asset when, and only when:
  1. the contractual rights to the cash flows from the financial asset expire; or
  2. the entity transfers the financial asset that meet the conditions set out in IAS 39 (i.e. "**asset transfer test**") and

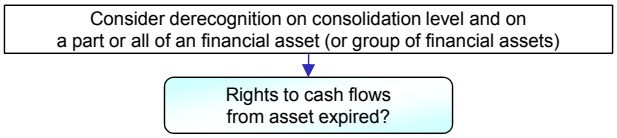
     the transfer qualifies for derecognition in accordance with IAS 39

     (i.e. the "**risks and rewards test**", and the "**control test**")

Derecognition of Financial Asset

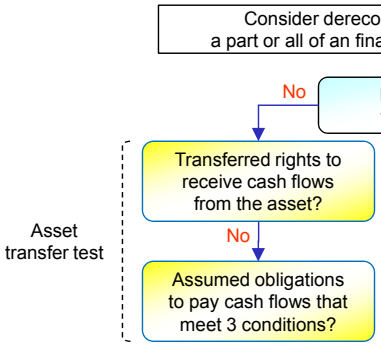


Derecognition of Financial Asset



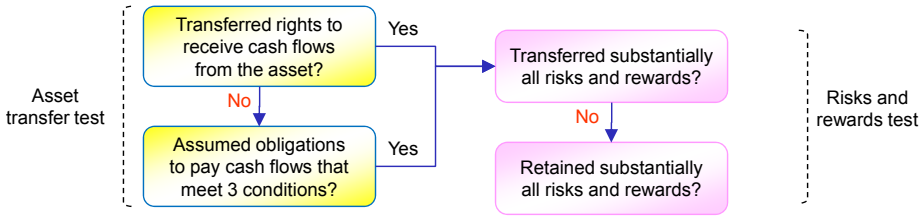
- The derecognition criteria
  - are applied consolidated level when an entity is a holding company
  - consider whether, and to what extent, the derecognition is appropriate on all or only a part of a (or group of) financial asset(s)
- One critical criterion to qualify for derecognition in IAS 39 is the expiry of contractual rights to receive cash flows from a financial asset.
- If the rights to receive cash flows from a financial asset have expired, the financial asset should be derecognised.
- The second criterion for derecognition includes two (or three) tests, namely
  - asset transfer test, risks and rewards test and control test, as discussed below

Derecognition of Financial Asset



- In order to meet the "**asset transfer test**", i.e. a financial asset is regarded as transferred, an entity either:
  1. transfers the contractual rights to receive the cash flows of the financial asset; or
  2. retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (the "eventual recipients") in an arrangement that meets the conditions set out in IAS 39.

Derecognition of Financial Asset



- When an entity transfers a financial asset (i.e. fulfilled the "asset transfer test"),
  - the entity is required to evaluate the extent to which it retains the risks and rewards of ownership of the financial asset before it can derecognise the financial asset. (i.e. the "**risks and rewards test**")

Derecognition of Financial Asset

Example

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

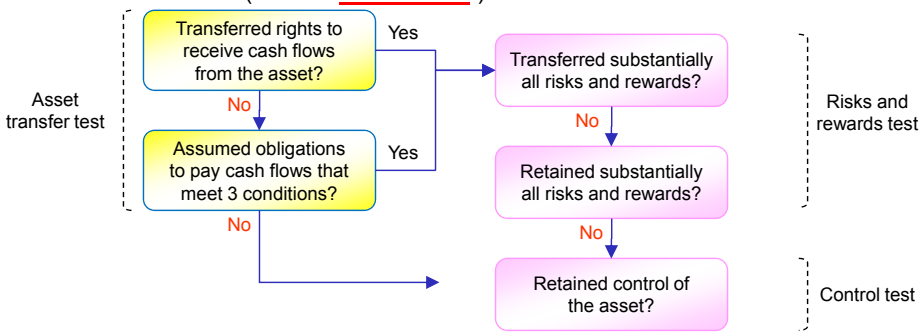
Transferred substantially all risks and rewards?

Retained substantially all risks and rewards?

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

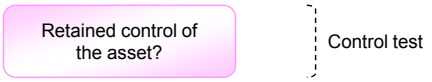
Derecognition of Financial Asset

- If an entity concludes that it neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset,
  - it will be required to determine whether it has retained control of the financial asset (i.e. the "**control test**").



Derecognition of Financial Asset

- To determine whether the control of the transferred asset is retained, an entity ascertains whether the transferee has ability to sell the asset.
  - If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control.
  - Because the entity does not control the transferee's use of the asset.
  - In all other cases, the entity has retained control.
- IAS 39 clarifies that the evaluation of the transfer of <u>risks and rewards of ownership</u> (i.e. the risks and rewards test) precedes the evaluation of <u>the transfer of control</u> (i.e. the control test) for all derecognition transactions.

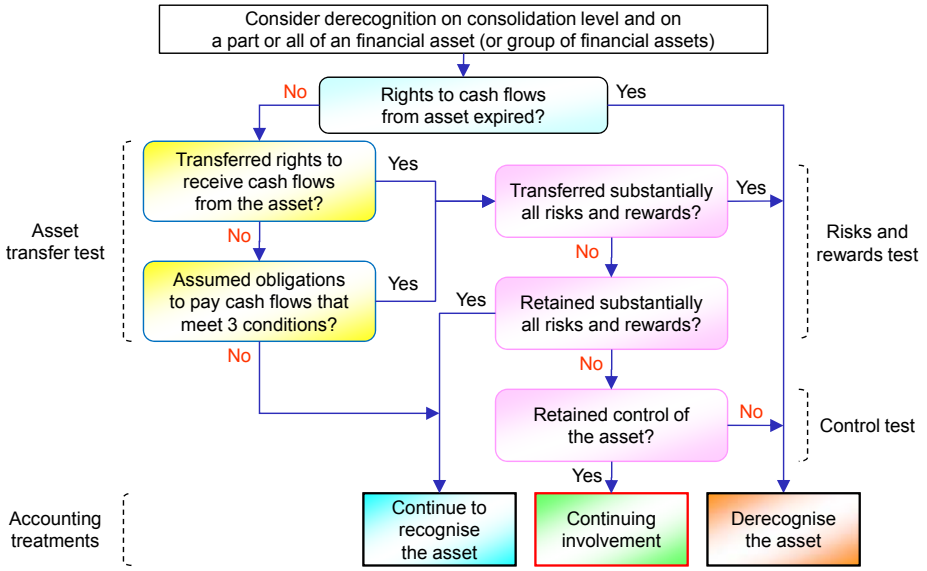


Derecognition of Financial Asset

- By applying the risks and rewards test together with the control test on a derecognition transaction:

Findings of risks & rewards test and control test	Corresponding accounting treatments
1. Transfers substantially all the risks and rewards of ownership	Transfer qualified for derecognition • To derecognise the financial asset • To recognise separately as assets/liabilities any rights & obligations created/retained in the transfer
2. Retains substantially all the risks and rewards of ownership	Transfer not qualified for derecognition • To continue to recognise the financial asset
3. Neither transfers nor retains substantially all the risks and rewards of ownership and not retained control	Transfer qualified for derecognition • To derecognise the financial asset • To recognise separately as assets/liabilities any rights & obligations created/retained in the transfer
4. Neither transfers nor retains substantially all the risks and rewards of ownership but retained control	Continuing involvement • To continuously recognise the financial asset to the extent of its continuing involvement in the asset • To recognise an associate liability

Derecognition of Financial Asset



Derecognition of Financial Asset

Example

- Melody Finance Corporation has disposed of its debt instruments issued by FTT plc to Bonnie Group at $350,000 and provided a guarantee to Bonnie for any default losses on the transferred debt instruments.
- Discuss the implication of the transaction.

- When a guarantee is provided by Melody for any default losses on the transferred asset, FTT's debt instruments, to Bonnie, Melody has retained substantially all the risks and rewards of ownership of the debt instruments.
- The transfer does not qualify for derecognition and it also prevents Melody to dereognise the debt instrument.
- The debt instrument continues to be recognised in its entirety in Melody's balance sheet (i.e. no entry will be made on the transfer side)

Derecognition of Financial Asset

Example

- Instead, the consideration received from Bonnie should be recognised as a liability as follows:

Dr	Cash	$350,000	
Cr		Financial liability	$350,000

- When an entity retains substantially all the risks and rewards of the transferred asset (e.g. in a sale and repurchase transaction), there are generally no special accounting considerations because the entity retains upside and downside exposure to gains and losses resulting from the transferred asset.
- In consequence, the transferred asset continues to be recognised in its entirety and the proceeds received from the transfer are recognised as a liability.
- Similarly, the entity continues to recognise any income from the asset along with any expense incurred on the associated liability.

Derecognition of Financial Asset

Case

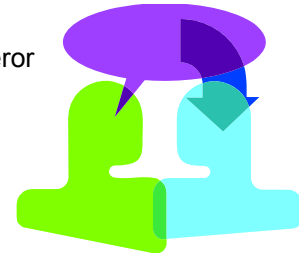
China Life Insurance Company Limited

- Accounting report 2006
  - China Life explained its accounting policy on accruing liabilities on the transfers of financial instruments not qualified for derecognition as follows:
    - Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within 180 days from the transaction date.
    - The Group may be required to provide additional collateral based on the fair value of the underlying securities.
    - Securities sold under agreements to repurchase are recorded at their cost plus accrued interest at the balance sheet date.
    - It is the Group's policy to maintain effective control over securities sold under agreements to repurchase which includes maintaining physical possession of the securities.
    - Accordingly, such securities continue to be carried on the consolidated balance sheet.

Derecognition of Financial Asset

Requirements for All Transfers

- If a transferred asset continues to be recognised,
  - the asset and the associated liability cannot be offset.
- Similarly, the entity is not allowed to offset any income arising from the transferred asset with any expense incurred on the associated liability.
- If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee,
  - the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted.



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Derecognition of Financial Asset

Circumstances for the collateral	Requirements for the transferor	Requirements for the transferee
1. The transferee has the right by contract or custom to sell or repledge the collateral	• To continue to carry the collateral as its asset • To reclassify that asset in its balance sheet separately from other assets	• Not to recognise the collateral as an asset
2. The transferee sells collateral pledged to it	• To continue to carry the collateral as its asset	• Not to recognise the collateral as an asset • To recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral
3. The transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral	• To derecognise the collateral	• To recognise the collateral as its asset initially measured at fair value, or • If it has already sold the collateral, to derecognise its obligation to return the collateral

Derecognition of Financial Liability

- An entity is required to remove a financial liability (or a part of a financial liability) from its balance sheet (i.e. derecognise a financial liability) when, and only when, it is extinguished.
  - IAS 39 explains that a financial liability is extinguished
    - when the obligation specified in the contract is discharged or cancelled or expires.
- A financial liability or part of it is extinguished when the debtor either:
  1. discharges the liability or part of it by paying the creditor, normally with cash, other financial assets, goods or services; or
  2. is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor.

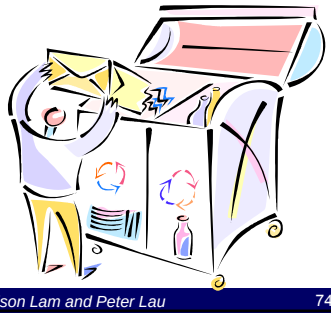
Derecognition of Financial Liability

- When there is an exchange between an existing borrower and lender of debt instruments with substantially different terms or a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor),
  - such an exchange of debt instruments or substantial modification of terms is accounted for as:
    - an extinguishment of the original financial liability and
    - the recognition of a new financial liability.

Derecognition of Financial Liability

- The recognition of a new financial liability
  - implies that the new liability is measured at fair value plus transaction costs at the date of extinguishment.
- The difference between
  - the carrying amount of a financial liability (or part of it) extinguished or transferred to another party and
  - the consideration paid, including any non-cash assets transferred or liabilities assumed,

  is recognised in profit or loss.



Today's Agenda

Derivatives

- Accounting for derivatives and embedded derivatives

Derivative & Embedded Derivative

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

a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying');

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

c) it is settled at a future date.

Value change based on an underlying

Little or no initial net investment

Settled at a future date

Financial instrument → Financial asset / Financial liability

Derivative

or Equity instrument

Derivative & Embedded Derivative

Example

Derivative

Typical example:

- Future and forward
- Swap and options

Value change based on an underlying

Little or no initial net investment

Settled at a future date

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

Derivative & Embedded Derivative

Derivative

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

Initial measurement

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

Subsequent measurement

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

Derivative & Embedded Derivative

Case

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

- Accounting report 2006

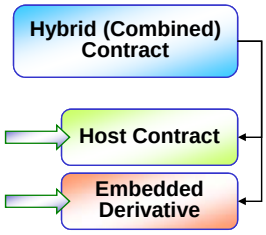
  Derivative financial instruments

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

Dr	Asset
Cr	Cash
Dr	Cash
Cr	Liabilities

Derivative & Embedded Derivative

- A holder of a hybrid (combined) instrument is required to evaluate whether the embedded derivative should be separately accounted for in accordance with IAS 39.
- A hybrid instrument includes
  - a non-derivative host contract and
  - an embedded derivative with the effect that some of the cash flows of the hybrid instrument vary in a way similar to a stand-alone derivative.
- However, a derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.



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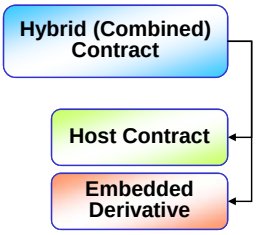
Derivative & Embedded Derivative

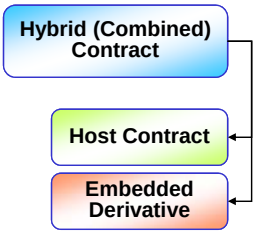
Example

- Examples of contract with embedded derivative include:
  1. A call, put, or prepayment option embedded in a host debt contract.
  2. An option or automatic provision to extend the remaining term to maturity of a debt instrument.
  3. Equity-indexed interest or principal payments embedded in a host debt instrument.
  4. Commodity-indexed interest or principal payments embedded in a host debt instrument.
  5. An equity conversion feature embedded in a convertible debt instrument.

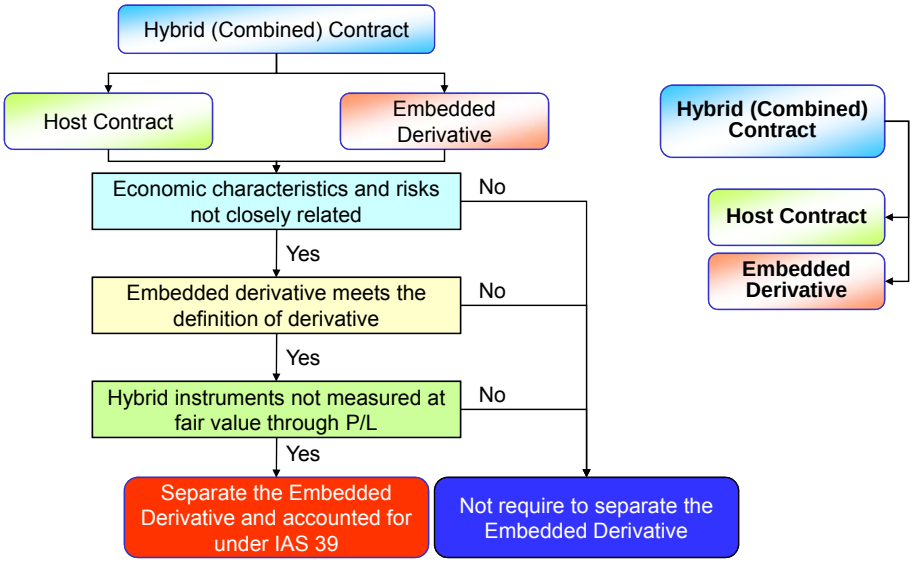


Derivative & Embedded Derivative

- IAS 39 requires an entity to separate an embedded derivative from the host contract and account for such embedded derivative as a derivative if, and only if:
  1. the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
  2. a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
  3. the hybrid instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).



Derivative & Embedded Derivative



Derivative & Embedded Derivative

Economic characteristics and risks NOT closely related

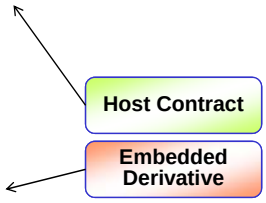
To assess economic characteristics and risks

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

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

Derivative & Embedded Derivative

- If an embedded derivative is separated, the host contract is accounted for
  - under IAS 39 if it is a financial instrument, and
  - in accordance with other appropriate accounting standards if it is not a financial instrument.
- IAS 39 does not address whether an embedded derivative is presented separately on the face of the financial statements.
- The separated embedded derivative is similar to a simple derivative to be accounted for in the same manner as other derivatives.



Derivative & Embedded Derivative

- 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:
  1. the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or
  2. it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

Derivative & Embedded Derivative

- If an entity is required by IAS 39 to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately (either at acquisition or subsequently),
  - the entity is required to designate the entire hybrid contract as at fair value through profit or loss.

Hybrid (Combined) Contract

Derivative & Embedded Derivative

Example

Index-linked Principal

- Entity A purchases a 5-year equity-index-linked note with an original issue price of $10 at a market price of $12 at the time of purchase.
- The note requires no interest payments before maturity.
- At maturity, the note requires
  - Payment of the original issue price of $10
  - Plus a supplemental redemption amount that depends on whether
    - a specified share price index > a predetermined level at the maturity date.
  - If the share index < or = the predetermined level
    - the supplemental redemption amount is zero
  - If the share index > the predetermined level
    - the supplemental redemption amount equal a factor of level of the share index at maturity
- Entity A has the positive intention and ability to hold the note to maturity.
- Can Entity A classify the note as a held-to-maturity investment?

Derivative & Embedded Derivative

Example

Index-linked Principal

Yes, subject to the separation of embedded derivative.

- The note can be classified as a HTM investment because
  - it has a fixed payment of $10 and fixed maturity and
  - Entity A has the positive intention and ability to hold it to maturity.
- However, the equity index feature is a call option not closely related to the debt host, which must be separated as **an embedded derivative**.
- The purchase price of $12 is allocated between
  - the host debt instrument and
  - the embedded derivative
- For example
  - if the fair value of the embedded option at acquisition is $4
  - the host debt instrument is measured at $8 on initial recognition
  - Then, the discount of $2 that is implicit in the host bond (principal of $10 minus the original carrying amount of $8) is amortised to profit or loss over the term to maturity of the note using the effective interest method.

Derivative & Embedded Derivative

Example

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

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

Yes, but ……

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

IAS 32, IAS 39, IFRS 4 and IFRS 7
(Part 2)

October 2008

Full set of slides in PDF may be found in
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