Financial Instrument Standards – Part I

(HKAS 32 and 39) January 2006

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The 2 Standards on Financial Instruments

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 ……

HKAS 32 ⇒ Disclosure and presentation

HKAS 39 ⇒ Recognition and measurement

The 2 Standards on Financial Instruments

Case

Hang Seng Bank *(2004 Annual Report)*

- On 1 January 2005, the Group has *reclassified most* of its Held-to-Maturity debt securities as Available-for-Sale securities.
- The change in fair value will cause *volatility* to the shareholders' equity.

Why reclassified most?

Why volatility to equity?

恒 生 銀 行
HANG SENG BANK

The 2 Standards on Financial Instruments

Case

Hang Seng Bank *(2004 Annual Report)*

- On adoption of HKAS 39, *all derivatives* will be recognised as either assets or liabilities in the balance sheet at fair value and the change in fair value is recognised as follows:
  - for a derivative designated as a Fair Value Hedge, in the profit and loss account together with the associated loss or gain on the hedged item;
  - for a derivative designated as a Cash Flow Hedge, initially in equity reserve and subsequently released into the profit and loss account in line with the income of the hedged assets/liabilities; and
  - for other derivatives (including dealing derivatives and non qualifying hedges), in the profit and loss account.
- There will be *higher volatility in income* as a result of the stricter definition of a qualifying hedge.
- The change in fair value of derivatives designated as Cash Flow Hedges will create *volatility in equity*.

恒 生 銀 行
HANG SENG BANK

Topics to be discussed

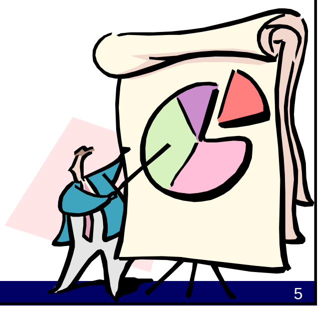
- Scope of HKAS 32 and 39
- Definitions and Classification (HKAS 32 and 39)
- Initial recognition and measurement (HKAS 39)
- Financial assets – measurement (HKAS 39)
- Financial liabilities – measurement (HKAS 39)
- Transitional arrangement (HKAS 39)

Simple but Comprehensive

Key Issues

Cases and Examples

Mainly from a commercial firm's point of view



Some Simple Questions First ……

- **How many pages do we have for HKAS 32 and 39?**

➢ HKAS 32		76
➢ HKAS 39	157	
➢ HKAS 39 – Guidance on Implementing excluding amendments	179	
		<u>336</u>
		412

- **Are there any listed companies in HK early adopted HKAS 32 and 39?**
  - ➢ Hong Kong Exchanges and Clearing Limited
  - ➢ Esprit Holdings Limited
  - ➢ Beijing Enterprises Holdings Limited

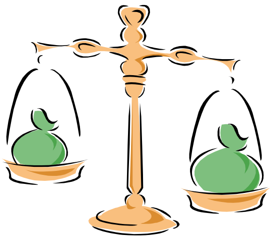
While they early adopted the full set of new/revised HKFRS/HKAS ……

Scope of HKAS 32 and 39

Scope – Excluded from HKAS 32 and 39

	HKAS 32	HKAS 39
Interests in subsidiaries, associates and joint ventures accounted for under HKAS 27, 28 and 31	×	×
Rights and obligations under leases to which HKAS 17 applies except for derecognition and embedded derivatives		×
Employers' rights and obligations under employee benefit plans, to which HKAS 19 applies	×	×
Financial instruments issued by the entity that meet the definition of an equity instrument in HKAS 32		×
Rights and obligations under an insurance contract as defined in HKFRS 4, except for embedded derivatives	×	×
Contracts for contingent consideration in a business combination (see HKFRS 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 (HKAS 37 and 18)		×
Instruments and obligations under share-based payment transactions (HKFRS 2), except for some contracts	×	×

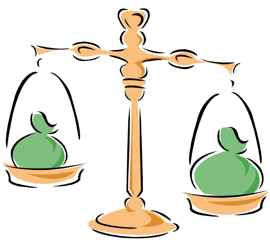
Definitions and Classification



Definitions

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



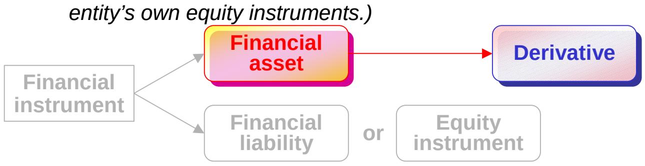
Financial instrument → Financial asset → of one entity

Financial instrument → Financial liability or Equity instrument → of another entity

Definitions – Financial Instruments

Financial asset is any asset that is:

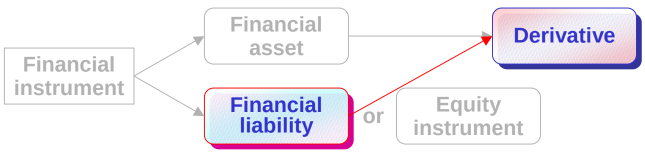
- Cash
- An equity instrument of another entity
- A contractual right
  - i) to receive cash or another financial asset from another entity
  - ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity
- A contract that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



Definitions – Financial Instruments

Financial liability is any liability that is

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



Definitions – Financial Instruments

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

Financial instrument

Financial asset

Financial liability or **Equity instrument**

Derivative

Definitions – Financial Instruments

Example

Gold Bullion

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

It is a commodity.

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

Financial instrument

Financial asset

Financial liability or Equity instrument

Derivative

Definitions – Derivative

Derivative ⇒ is a <u>financial instrument</u> or other contract within the scope of HKAS 39 with all 3 of the following characteristics:

Value change based on an underlying

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');

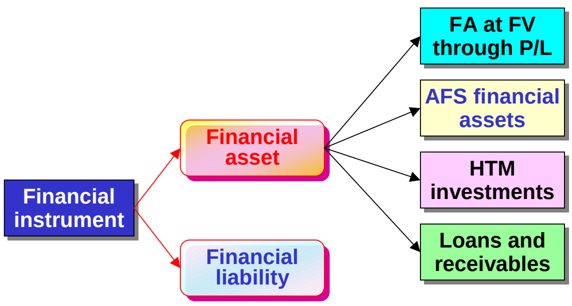
Little or no initial net investment

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

Settled at a future date

c) it is settled at a future date.

Definitions and Classification



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

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

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

Definitions and Classification

Financial asset

FA at FV through P/L

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

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

a) It is classified as **held for trading**, if it is: — **An entity has NO choice**

   i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

   ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

   iii) a derivative (except for a derivative that is a designated and effective hedging instrument).

b) Upon **initial recognition** it is **designated** by the entity as at fair value through profit or loss, except for investments in equity instruments that — **An entity has a choice**

   - do not have a quoted market price in an active market,
   - and whose fair value cannot be reliably measured.

But …… new requirements for 2006 (to be discussed)

Definitions and Classification

Financial asset

Example

FA at FV through P/L

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

- ABC co. purchases some HK listed equity securities as its investments the first time.
- It intends to take profit on selling them if their prices are favorable; otherwise, it will hold it until it has a liquidity need.
- How should it classify its securities under HKAS 39?

- Unclear length of holding, not necessarily selling in near term
- No recent actual short-term profit taking
- The securities are not derivative

⇒ ABC has a choice to designate it as:
  - FA at FV through P/L or
  - AFS financial assets (discussed later)

Definitions and Classification

Financial asset

Example

FA at FV through P/L

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

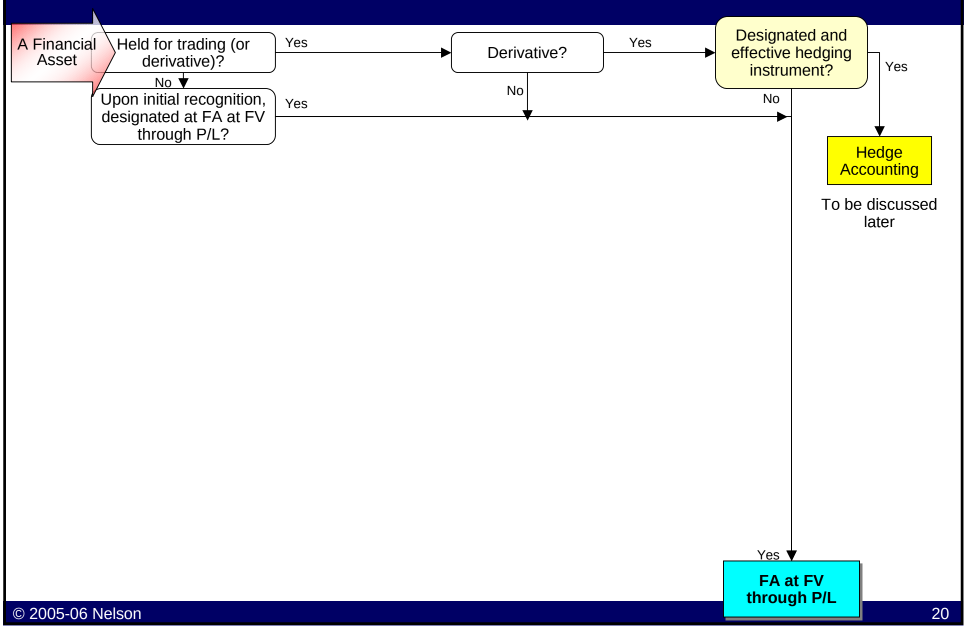
Balancing a Portfolio

- Entity A has an investment portfolio of debt and equity instruments.
- The documented portfolio management guidelines specify that the equity exposure of the portfolio should be limited to between 30% and 50% of total portfolio value.
- The investment manager of the portfolio is authorised to balance the portfolio within the designated guidelines by buying and selling equity and debt instruments.
- Is Entity A permitted not to classify the instruments as held for trading?

- It depends on Entity A's intentions and past practice.
- If the portfolio manager is authorised to buy and sell instruments to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the instruments are not classified as held for trading.
- If the portfolio manager actively buys and sells instruments to generate short-term profits, the financial instruments in the portfolio are classified as held for trading.

Definitions and Classification

Financial asset



Definitions and Classification

Financial asset

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

Definition – for Available-for-sale financial assets

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

An entity has a choice

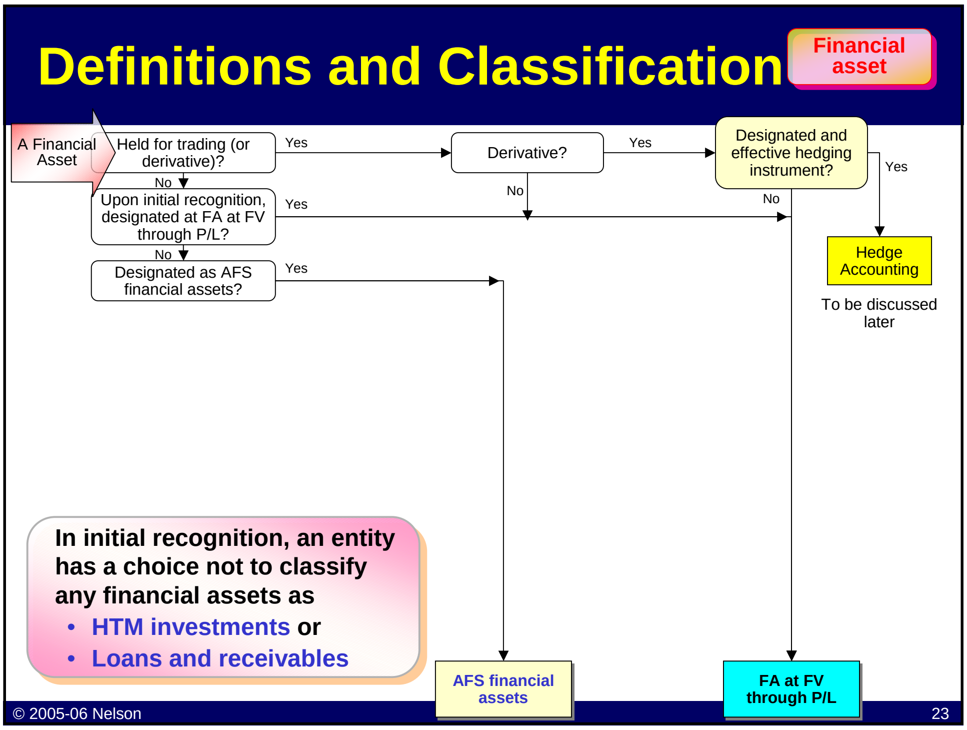
- Implies
  - ⇒ Except for those held for trading, all the remaining financial assets can be designated as AFS financial assets
  - ⇒ Loans and receivables and HTM investments can also be initially designated as AFS financial assets

Measurement – Classification

Case

Li & Fung Limited

- In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:
  - Available-for-sale financial assets are non-derivatives that are either
    - designated in this category or
    - not classified in any of the other categories (i.e. loans and receivables, financial assets at fair value through profit or loss and held-to-maturity investments).
  - They are included in non-current assets unless management intends to dispose of the investment within 12 months of the balance sheet date.


Definitions and Classification
Financial asset
A Financial Asset
Held for trading (or derivative)?
Yes
Derivative?
Yes
Designated and effective hedging instrument?
Yes
Hedge Accounting
To be discussed later
No
Upon initial recognition, designated at FA at FV through P/L?
Yes
No
No
No
Designated as AFS financial assets?
Yes
In initial recognition, an entity has a choice not to classify any financial assets as
• HTM investments or
• Loans and receivables
AFS financial assets
FA at FV through P/L
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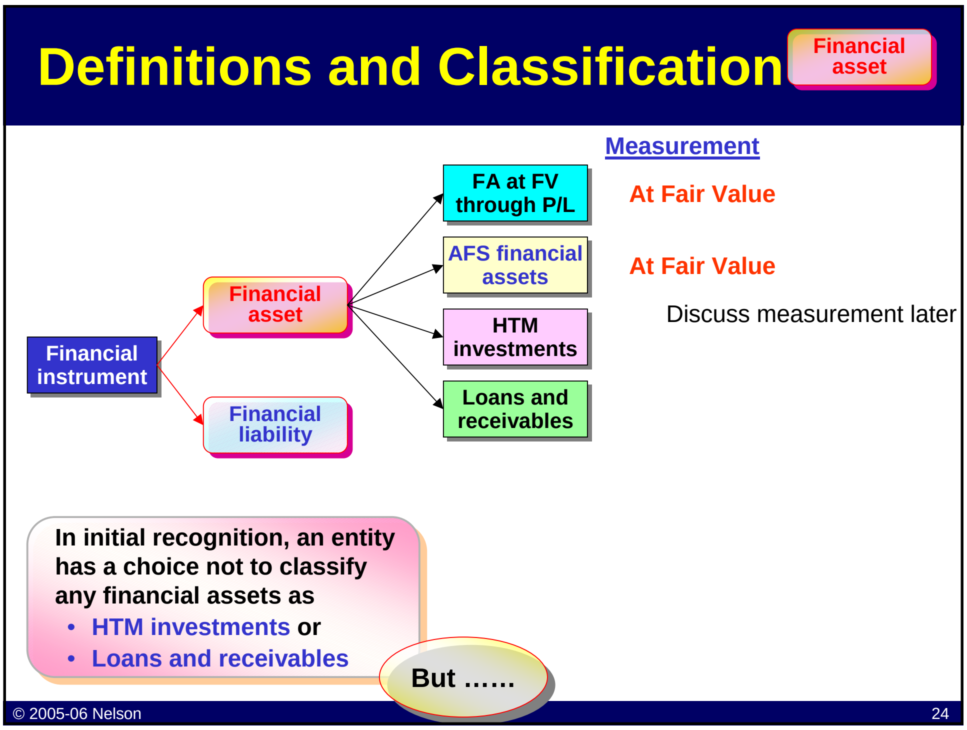
Definitions and Classification
Financial asset
Measurement
FA at FV through P/L
At Fair Value
AFS financial assets
At Fair Value
HTM investments
Discuss measurement later
Loans and receivables
Financial instrument
Financial asset
Financial liability
In initial recognition, an entity has a choice not to classify any financial assets as
• HTM investments or
• Loans and receivables
But ……
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Definitions and Classification

Financial asset

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

Definition for Held-to-Maturity Investments

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

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

Definitions and Classification

Financial asset

Example

HTM investments

Definition for Held-to-Maturity Investments

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

- 5% 5-Year note ⇒ √ HTM investments
- HIBOR 3-Year bank note ⇒ √ HTM investments
- 10% 1-year equity-linked note (at maturity, ABC co. can receive either principal with interest or HSBC shares if the price of HSBC shares falls below $120 each) ⇒ √ but the put option element shall be separated and accounted for as Embedded Derivative *(not to be discussed today)*

Definitions and Classification

Financial asset

Example

HTM investments

Definition

for Held-to-Maturity Investments

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.

Definitions and Classification

Financial asset

HTM investments

Definition

for Held-to-Maturity Investments

No Positive Intention to Hold to Maturity

- An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:
  a) the entity intends to hold the financial asset for an undefined period;
  b) the entity stands ready to sell the financial asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the entity) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or
  c) the issuer has a right to settle the financial asset at an amount significantly below its amortised cost.

Definitions and Classification

Financial asset

Example

HTM investments

Definition
for Held-to-Maturity Investments

Callable bond

- Entity A buys a callable bond and the bond issuer has a call option.
- Can Entity A classify the bond as a HTM investment?

Yes
- If the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount.
- The call option of the issuer, if exercised, simply accelerates the asset's maturity.

Definitions and Classification

Financial asset

Example

HTM investments

Definition
for Held-to-Maturity Investments

Puttable bond

- Entity A buys a puttable bond and Entity A has a put option to require the issuer to redeem the bond.
- Can Entity A classify the bond as a HTM investment?

No!
- A financial asset that is puttable (i.e. the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a HTM investment.
- Because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.

Definitions and Classification

Financial asset

HTM investments

Definition
for Held-to-Maturity Investments

No Positive Ability to Hold to Maturity

- An entity does not have a demonstrated ability to hold to maturity an investment in a financial asset with a fixed maturity if:
  a) it does not have the financial resources available to continue to finance the investment until maturity; or
  b) it is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity.

Definitions and Classification

Financial asset

Subject to Tainting Rule below

HTM investments

Definition
for Held-to-Maturity Investments

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

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

Definitions and Classification

Financial asset

Example

Subject to Tainting Rule below → HTM investments

Definition
for Held-to-Maturity Investments

Examples of situation that sales before maturity still do not raise a question about the entity's intention to hold to maturity:

a) a significant deterioration in the issuer's creditworthiness
b) a change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the HTM investment.
c) a major business combination or major disposition (such as a sale of a segment) that necessitates the sale or transfer of HTM investments to maintain the entity's existing interest rate risk position or credit risk policy.
d) a change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of a HTM investment.
e) a significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling HTM investments.
f) a significant increase in the risk weights of HTM investments used for regulatory risk-based capital purposes.

Definitions and Classification

Financial asset

Example

Subject to Tainting Rule below → HTM investments

Definition
for Held-to-Maturity Investments

Sale of HTM investments

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

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

Definitions and Classification

Financial asset

Example

Subject to **Tainting Rule** below → HTM investments

Definition
for Held-to-Maturity Investments

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.
- HKAS 39 specifies that a sale due to a significant deterioration in the issuer's creditworthiness could satisfy the condition in HKAS 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 HKAS 39.

Definitions and Classification

Financial asset

Example

Subject to **Tainting Rule** below → HTM investments

Definition
for Held-to-Maturity Investments

Different categories of HTM Investments

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

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

No.

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

Definitions and Classification

Financial asset

Example

Subject to Tainting Rule below → HTM investments

Definition for Held-to-Maturity Investments

Different entities in a group

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

No.

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

Definitions and Classification

Financial asset

Case

Hang Seng Bank *(2004 Annual Report)*

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

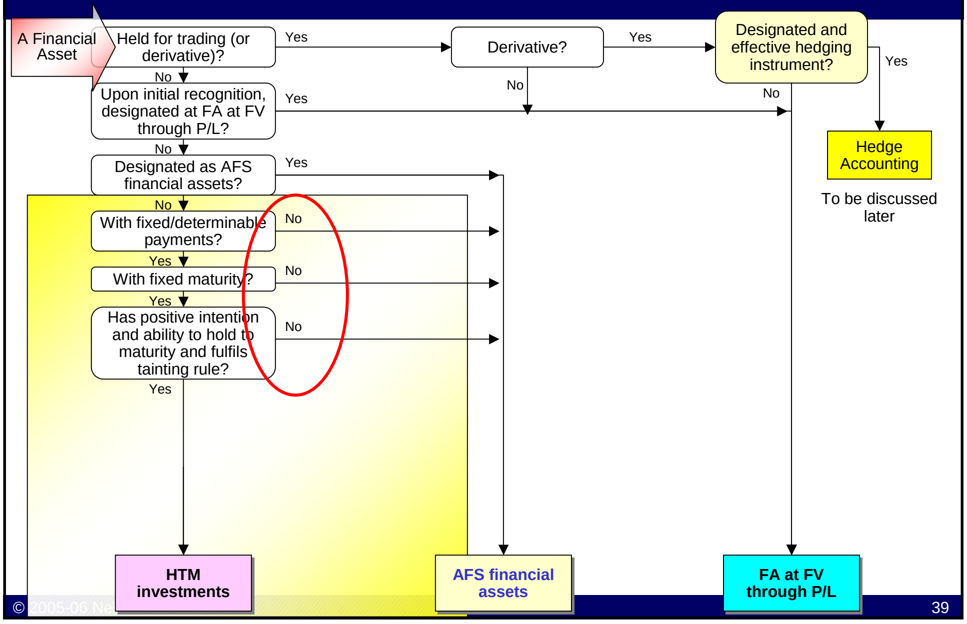
Explained why!

Why volatility to equity? to be discussed later

恒生銀行 HANG SENG BANK

Definitions and Classification

Financial asset



Definitions and Classification

Financial asset

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

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

Definitions and Classification

Financial asset

Example

Loans and receivables

Definition

Classification of Investment in Preference Share

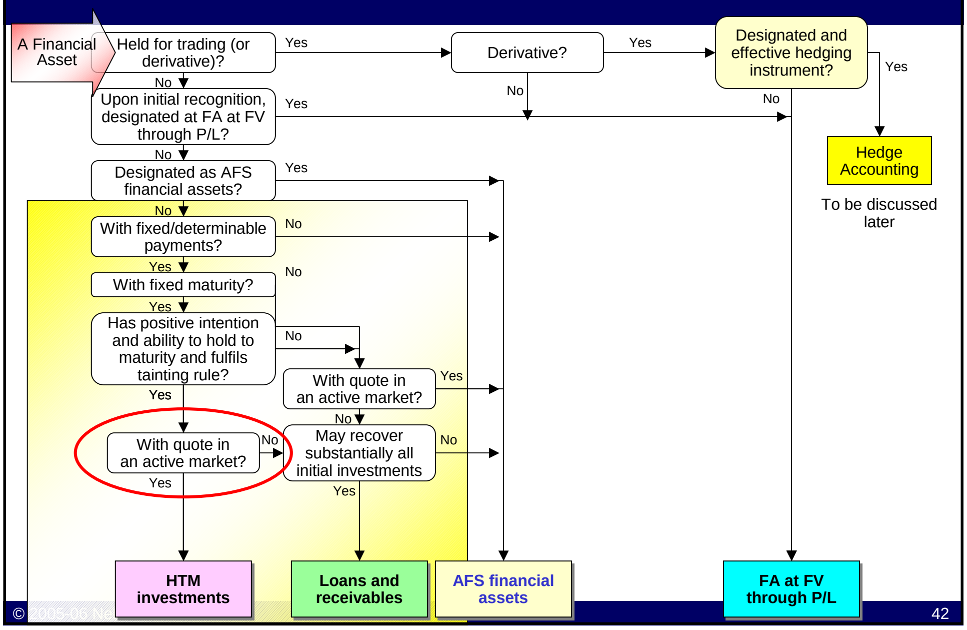
Can an equity instrument, such as a preference share, with fixed or determinable payments be classified within loans and receivables by the holder?

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.
- HKAS 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 HKAS 32, it cannot be classified within loans and receivables by the holder.

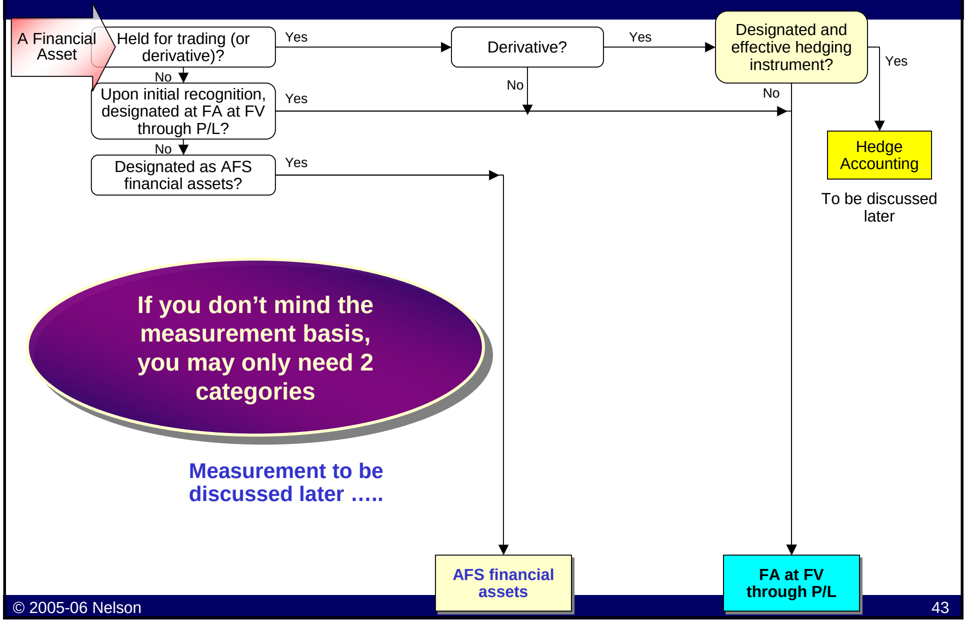
Definitions and Classification

Financial asset

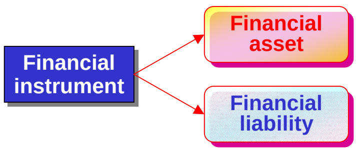


Definitions and Classification

Financial asset



Initial Recognition



Initial Recognition

Financial instrument
Financial asset
Financial liability

Initial Recognition
Trade Date Accounting
Regular Way of Financial Assets

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

Initial Recognition

Financial instrument
Financial asset
Financial liability

Initial Recognition
Trade Date Accounting
Regular Way of Financial Assets

Initial Measurement
Fair Value
+
Transaction Cost

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

Why?

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

Initial Recognition

Financial asset ↔ Derivative

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

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

Initial Recognition

Financial asset ↔ Derivative

Trade date is the date that an entity commits itself to purchase or sell an asset.

- **Trade date accounting** refers to
  a) the recognition of an asset to be received and the liability to pay for it on the **trade date**, and
  b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the **trade date**.
  Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

Settlement date is the date that an asset is delivered to or by an entity.

- **Settlement date accounting** refers to
  a) the recognition of an asset on the day it is **received by the entity**, and
  b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is **delivered by the entity**.

Initial Recognition

Financial asset ↔ Derivative

- When **settlement date accounting** is applied
  - an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset.
  - In other words,
    - ➢ the change in value is <u>not recognised</u> for assets carried at cost or amortised cost;
    - ➢ it is <u>recognised in profit or loss</u> for assets classified as financial assets at fair value through profit or loss; and
    - ➢ it is <u>recognised in equity</u> for assets classified as available for sale.

Initial Recognition

Example

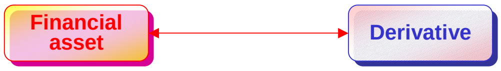
Financial asset ↔ Derivative

<u>Recognition as assets or liabilities?</u>

- Unconditional receivables and payables when the entity becomes a party to the contract √
- Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services ×
- A forward contract that is within the scope of HKAS 39 on the commitment date √
- Option contracts that are within the scope of HKAS 39 when the holder or writer becomes a party to the contract √
- Planned future transactions ×

Initial Recognition

Example



Regular Way Contract

- Entity ABC enters into a forward contract, which
  - allows ABC to purchase 1 million M's ordinary shares in 2 months for $10 per share
  - is with an individual and is not an exchange-traded contract
  - requires ABC to take physical delivery of the shares and pay the counterparty $10 million in cash
- M's shares trade in an active public market at an average of 100,000 shares a day and regular way delivery is 3 days.
- Is the forward contract regarded as a regular way contract?

No.
- The contract must be accounted for as a derivative.
- Because it is not settled in the way established by regulation or convention in the marketplace concerned.

Initial Recognition

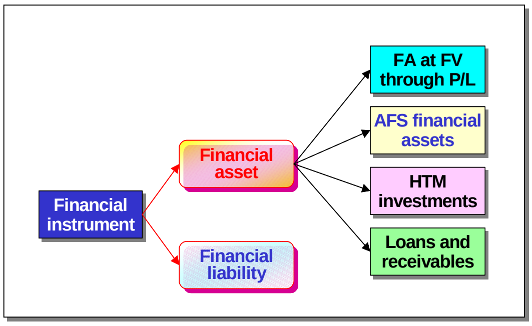
Example

Fair value at Initial Recognition – Low Interest Loan

- Entity A grants a 3-year loan of 50,000 to an important new customer
- The interest rate on the loan is 4%, while the current market lending rates for similar loans to customers with a similar credit risk profile is 6%
- Entity A believes that the future business to be generated with this new customer will lead to a profitable lending relationship.

- On initial recognition, Entity A should recognise the carrying amount of the loan at the fair value of the payments that it will receive from the customer.
- Discounting the interest and principal repayments using the market rate of 6%, Entity A will recognise an originated loan of $47,328.
- The difference of $2,672 is expensed immediately as the expectation about future lending relationships does not qualify for recognition as an intangible asset.

Financial Assets – Measurement



- Measurement after recognition
- Impairment
- Reclassification

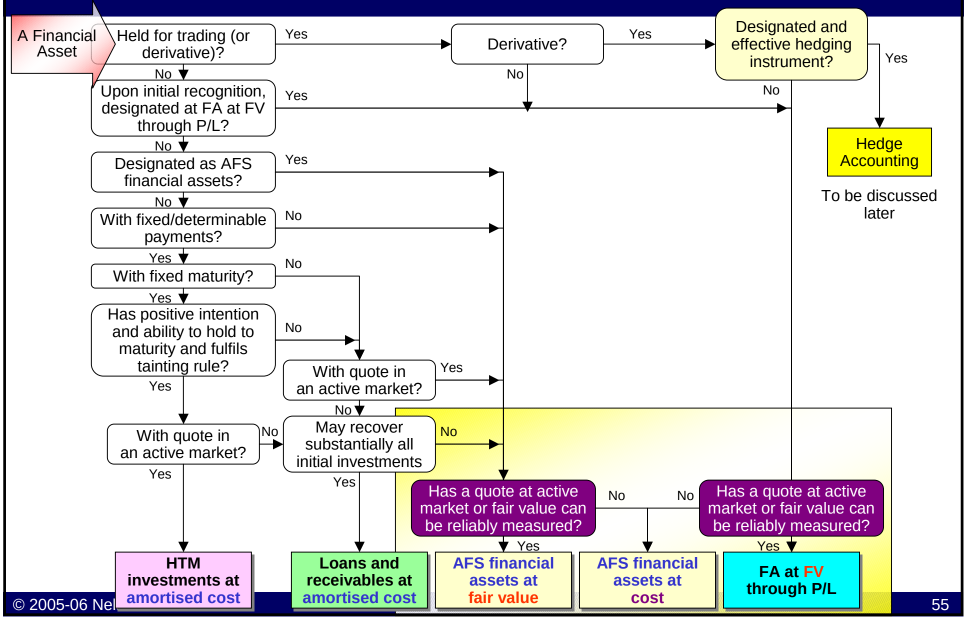
Measurement after Recognition

Classification determine
Subsequent Measurement

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

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

Measurement after Recognition



Measurement after Recognition

Subsequent Measurement

FA at FV through P/L	**at Fair Value ⇨ Gain or loss to ⇨ Profit or loss**
AFS financial assets	**at Fair Value ⇨ Gain or loss to ⇨ Equity** **at Cost**
HTM investments	**at Amortised Cost** using the effective interest method
Loans and receivables	**at Amortised Cost** using the effective interest method

Measurement after Recognition

Subsequent Measurement

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

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

Measurement after Recognition

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

Active market exists

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

Measurement after Recognition

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

No active market
- An entity establishes fair value by using a valuation technique
- To establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations
- Valuation techniques include
  - Using recent arm's length market transactions between knowledgeable, willing parties
  - Discounted cash flow analysis
  - Option pricing models

Measurement after Recognition

Example

Fair Value of Quoted Price

- Financial Controller, Ms. Luk, manages a fund and the rules applicable to the fund require net asset values to be reported to investors on the basis of mid-market prices.
- In these circumstances, would it be appropriate for an investment fund to measure its assets on that basis in the balance sheet of the fund?

No.
- The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in HKAS 39 to use the current bid price in the absence of a matching liability position.
- In its financial statements, an investment fund measures its assets at current bid prices.
- In reporting its net asset value to investors, an investment fund may wish to provide a reconciliation between the fair values recognised on its balance sheet and the prices used for the net asset value calculation.

Measurement after Recognition

Example

Block Premium on Quoted Shares

- Entity A holds 15% Entity B's share capital
  - It is publicly traded in an active market with a currently quoted price of $100.
  - Daily trading volume of Entity B's shares is 0.1% of its outstanding shares.
- Entity A believes that the fair value of the Entity B shares it owns, if sold as a block, is greater than the quoted market price
- Entity A obtains several independent estimates of the price it would obtain if it sells its holding.
- These estimates indicate that Entity A would be able to obtain a price of $105, i.e. a 5% premium above the quoted price.
- Which figure should Entity A use for measuring its holding at fair value?

> - Under HKAS 39, a published price quotation in an active market is the best estimate of fair value.
> - Therefore, Entity A uses the published price quotation ($100).
> - Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

Measurement after Recognition

Case

香 港 公 益 金
THE COMMUNITY CHEST

Any changes required?

Accounting policy on investments (annual report 2004/05):

- Investments of the Endowment Funds, Operations Fund, Liquid Fund and donated investments pending realisation are stated at their fair values based on their quoted market prices at the balance sheet date without any deduction for estimated future selling costs.
- Listed securities are priced at last traded prices while unlisted securities are priced at quoted market price available from a broker or dealer for non-exchange-traded financial instruments.
- Investments in unlisted open-ended investment funds are recorded at the net asset value per share as reported by the managers of such funds.
- Changes in fair value are recognised in the Income and Expenditure Statement as they arise.

Measurement after Recognition

Case

Li & Fung Limited

- In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:
  - The fair values of quoted investments 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,
    - reference to other instruments that are substantially the same,
    - discounted cash flow analysis, and
    - option pricing models refined to reflect the issuer's specific circumstances.

Measurement after Recognition

Subsequent Measurement

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

For investments in equity instruments that
- do not have a quoted market price in an active market, and
- whose fair value cannot be reliably measured
  - Included those derivatives that are linked to and must be settled by delivery of such quoted equity instruments

Measurement after Recognition

Subsequent Measurement

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

Amortised cost of a financial instrument is:

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

Measurement after Recognition

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

Measurement after Recognition

- 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.

- 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 HKAS 18), transaction costs, and all other premiums or discounts.

Measurement after Recognition

Case

Hang Seng Bank *(2004 Annual Report)*

Loan fee income and costs

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

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HANG SENG BANK

Measurement – Impairment

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

Impairment

At each balance sheet date

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

Measurement – Impairment

Outside the scope of HKAS 36

Conditions for Impairment

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

Measurement – Impairment

Outside the scope of HKAS 36

Examples of objective evidence of impairment:

a) significant financial difficulty of the issuer or obligor;

b) a breach of contract, such as a default or delinquency in interest or principal payments;

c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;

d) it becomes probable that the borrower will enter bankruptcy or other financial reorganisation;

e) the disappearance of an active market for that financial asset because of financial difficulties; or

f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

   i) adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments); or

   ii) national or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate or a decrease in property prices the area).

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

FA at FV through P/L — at **Fair Value** ➡ Implicitly, no impairment review is needed as gain or loss on change in fair value is recognised in profit or loss

AFS financial assets

HTM investments

Loans and receivables

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

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

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

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

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

Sequence of Impairment Assessment

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

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

FA at FV through P/L — at Fair Value

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

HTM investments

Loans and receivables

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

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

FA at FV through P/L — at Fair Value

AFS financial assets — **at Fair Value**

HTM investments

Loans and receivables

Implication?

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

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

Measurement – Impairment

Example

Impairment reserves

- In view of the market downturn, Entity C proposes to recognise impairment or bad debt losses in excess of impairment losses that are determined on the basis of objective evidence about impairment in loan receivables from customers.
- Does HKAS 39 permit such recognition?

No.

- HKAS 39 does not permit an entity to recognise impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or identified groups of financial assets with similar credit risk characteristics on the basis of objective evidence about the existence of impairment in those assets.
- Amounts that an entity might want to set aside for additional possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognised as impairment or bad debt losses under HKAS 39.

Measurement – Impairment

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.

- HKAS 39 requires financial asset to be initially measured at <u>fair value</u>.
- 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, HKAS 39 further requires that an impairment loss is recognised only if there is <u>objective evidence of impairment</u> as <u>a result of a past event</u> that occurred after initial recognition.
- Thus, it is inconsistent with HKAS 39 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.

Measurement – Impairment

Example

Impairment Based on Ageing Analysis

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

Not necessarily.

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

Measurement – Impairment

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 HKAS 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, HKAS 39 requires that the impairment of that asset should be recognised.
- HKAS 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 HKAS 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.

Measurement – Impairment

Example

Aggregate Fair Value Less Than Carrying Amount

- HKAS 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.
- HKAS 39 states that a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.
- Additionally, a decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (e.g. a decline in the fair value of a bond resulting from an increase in the basic risk-free interest rate).

Measurement – Impairment Case

Case

Hang Seng Bank *(2004 Annual Report)*

Provisions for bad and doubtful debts

- The current accounting policy on provisions for bad and doubtful debts is set out in note 3(c) above.
- Note 3(c) states that:
  - It is the Group's policy to make provisions for bad and doubtful debts promptly where required and on a prudent and consistent basis.
  - There are two basic types of provisions, specific and general, each of which is considered in terms of the charge and the amount outstanding.

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HANG SENG BANK

Measurement – Impairment Case

Case

Hang Seng Bank *(2004 Annual Report)*

Provisions for bad and doubtful debts

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

恒 生 銀 行 HANG SENG BANK

Measurement – Impairment Case

Case

HSBC

- HSBC has NOT early adopted IFRS and will convert from UK GAAP to IFRS in 2005
- Its US SEC filing stated that:
  - Under IAS 39, impairment provisions are recognised on an incurred loss basis when an entity has objective evidence that an advance is impaired.
  - Provisions under IAS 39 are calculated on a discounted future cash flow basis.
  - Individually assessed provisions are calculated using a discounted cash flow analysis for the impaired advance.
  - IAS 39 allows collective assessment of impairment for individually insignificant items or items where no impairment has been identified on an individual basis.
  - Formula-based approaches or statistical methods may be used to determine losses in groups of financial assets provided they
    - incorporate the effect of the time value of money,
    - consider the cash flows for the expected remaining life of the asset,
    - consider the age of the loans within the portfolio, and
    - do not give rise to an impairment loss on initial recognition of an asset.

Measurement – Impairment

Case

Li & Fung Limited

2005 Interim Report set out the impairment loss policy as follows:

- The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired.
- In the case of equity securities classified as available for sale, a significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the securities are impaired.
- If any such evidence exists for available-for-sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognized in the consolidated profit and loss account – is removed from equity and recognized in the consolidated profit and loss account.
- Impairment losses recognized in the consolidated profit and loss account on equity instruments are not reversed through the consolidated profit and loss account.

Measurement – Impairment

Outside the scope of HKAS 36

Impairment ← Is Reversal allowed?

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

Impairment losses on **equity instrument**

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

Impairment losses on **debt instrument**

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

Measurement – Impairment

Outside the scope of HKAS 36

Impairment ← Is Reversal allowed?

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

Such impairment losses shall NOT be reversed

Measurement – Impairment

Outside the scope of HKAS 36

Impairment ← Is Reversal allowed?

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

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

Measurement – Reclassification

Reclassification

FA at FV through P/L — **at Fair Value**

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

HTM investments — **at Amortised Cost**

Loans and receivables — **at Amortised Cost**

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.

Measurement – Reclassification

Reclassification

FA at FV through P/L — at Fair Value

AFS financial assets — at Fair Value / at Cost

HTM investments — **at Amortised Cost**

Loans and receivables — at Amortised Cost

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

Measurement – Reclassification

FA at FV through P/L — at Fair Value

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

HTM investments — at Amortised Cost

Loans and receivables — at Amortised Cost

Reclassification

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

Measurement – Reclassification

FA at FV through P/L — at Fair Value

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

HTM investments — **at Amortised Cost**

Loans and receivables — at Amortised Cost

Reclassification

- 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

Measurement – Reclassification

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

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.

Measurement – Summary

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

Measurement – From SSAP 24

SSAP 24 → **HKAS 39**

SSAP 24 not cover: **Loans and receivables**

Held-to-maturity

SSAP 24	Measurement	HKAS 39				
HTM debt securities	at Amortised Cost less provision →	HTM investments	or	FA at FV through P/L	or	AFS financial assets

HTM investments:
- At amortised cost
- Observe strict tainting rules
- Observe impairment

AFS financial assets:
- At Fair Value through Equity, unless no reliable fair value
- Observe impairment

Benchmark treatment

SSAP 24	Measurement	HKAS 39				
Investment securities	at Cost less provision →			FA at FV through P/L	or	AFS financial assets
Other investments	at Fair Value through P/L →			FA at FV through P/L	or	AFS financial assets

Alternative treatment

SSAP 24	Measurement	HKAS 39				
Trading securities	at Fair Value through P/L →			FA at FV through P/L		
Non-Trading securities	at Fair Value through Equity →			FA at FV through P/L	or	AFS financial assets

Measurement – Fr

Is there any choice with minimum impact?

SSAP 24 → **HKAS 39**

Held-to-maturity

SSAP 24	Measurement	HKAS 39				
HTM debt securities	at Amortised Cost less provision →	HTM investments	or	FA at FV through P/L	or	AFS financial assets

HTM investments:
- At amortised cost
- Observe strict tainting rules
- Observe impairment

AFS financial assets:
- At Fair Value through Equity, unless no reliable fair value
- Observe impairment

Benchmark treatment

SSAP 24	Measurement	HKAS 39				
Investment securities	at Cost less provision →			FA at FV through P/L	or	AFS financial assets
Other investments	at Fair Value through P/L →			FA at FV through P/L	or	AFS financial assets

Alternative treatment

SSAP 24	Measurement	HKAS 39				
Trading securities	at Fair Value through P/L →			FA at FV through P/L		
Non-Trading securities	at Fair Value through Equity →			FA at FV through P/L	or	AFS financial assets

Measurement – Fr... 24

Is there any choice with minimum impact?

SSAP 24 → **HKAS 39**

Held-to-maturity

- **HTM debt securities** at Amortised Cost less provision → **HTM investments**
  - At amortised cost
  - Observe strict tainting rules
  - Observe impairment

Benchmark treatment

- **Investment securities** at Cost less provision → **AFS financial assets**
  - At Fair Value through Equity, unless no reliable fair value
  - Observe impairment
- **Other investments** at Fair Value through P/L → **FA at FV through P/L**

Alternative treatment

- **Trading securities** at Fair Value through P/L → **FA at FV through P/L**
- **Non-Trading securities** at Fair Value through Equity → **AFS financial assets**

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Measurement – From SSAP 24

SSAP 24 → **HKAS 39**

SSAP 24 **Loans and**

Held-to-maturity

- **HTM debt securities** at Amortised Cost less provision →

Benchmark treatment

- **Investment securities** at Cost less provision →
- **Other investments** at Fair Value through P/L →

Alternative treatment

- **Trading securities** at Fair Value through P/L →
- **Non-Trading securities** at Fair Value through Equity →

At the beginning of the year of first adoption

- **"Tainting rules" waived on reclassifying HTM debt securities under SSAP 24 to HTM investments under HKAS 39**
  - Even an entity sold or transferred HTM debt securities in the 2 preceding years, it does not trigger the tainting rules and would not prevent an entity to classify HTM debt securities as HTM investments
- **Initial designation rule waived**
  - Allow entities to designate its instruments as
    - FA at FV through P/L or
    - AFS financial assets at the date of transition
- **Any adjustment of the carrying amount should be recognised to the opening balance of retained earnings**

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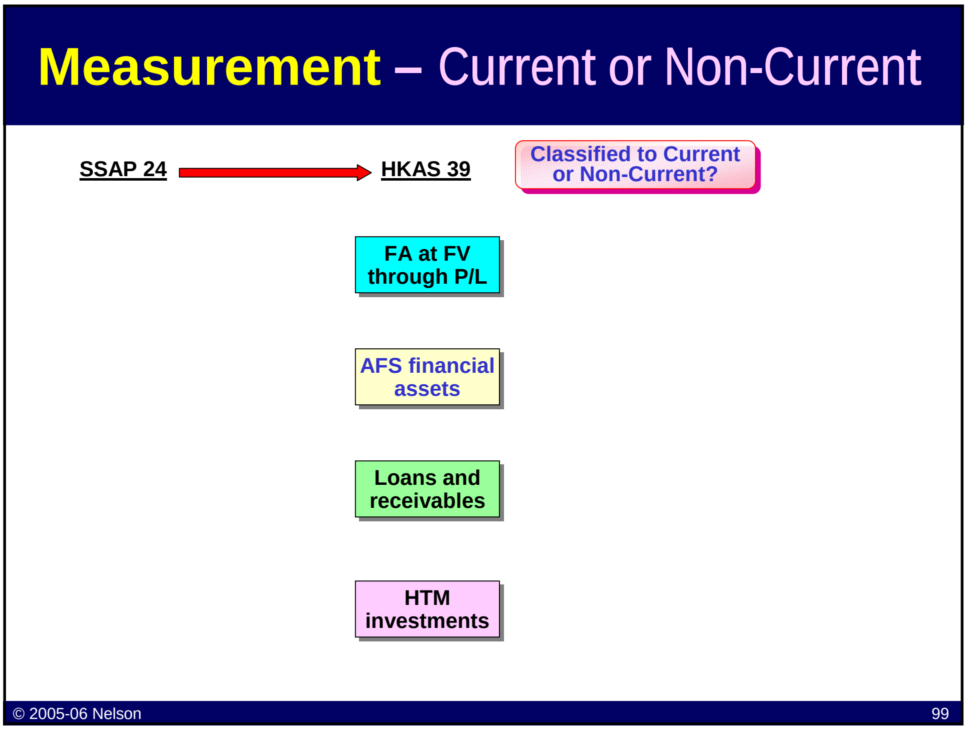
Measurement – Current or Non-Current
SSAP 24
HKAS 39
Classified to Current or Non-Current?
FA at FV through P/L
AFS financial assets
Loans and receivables
HTM investments
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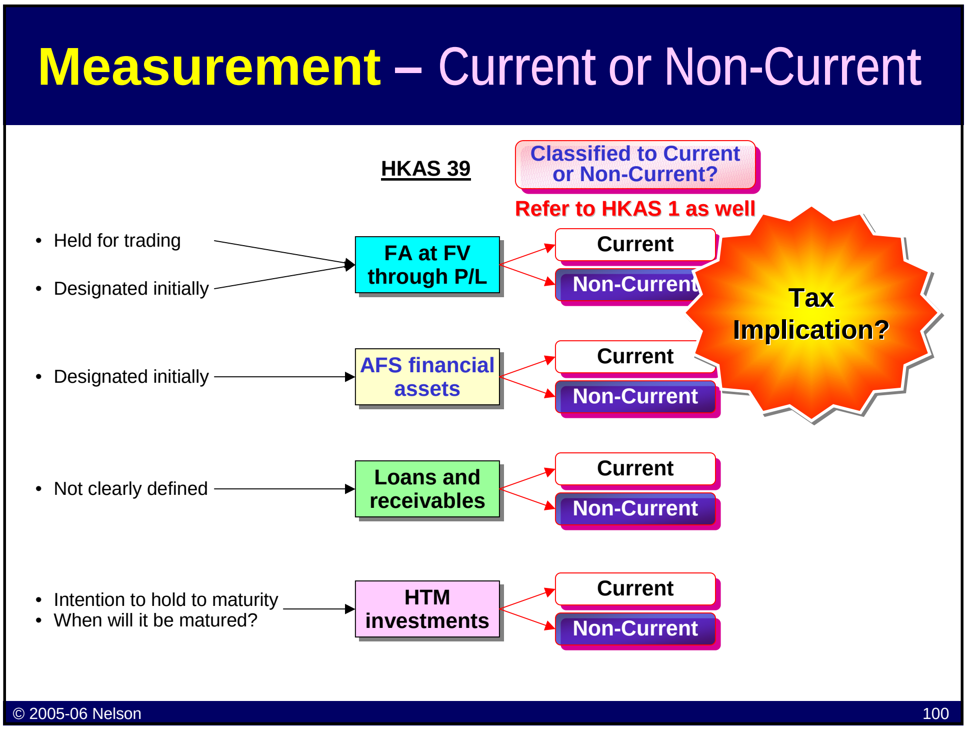
Measurement – Current or Non-Current
HKAS 39
Classified to Current or Non-Current?
Refer to HKAS 1 as well
Held for trading
Designated initially
FA at FV through P/L
Current
Non-Current
Tax Implication?
Designated initially
AFS financial assets
Current
Non-Current
Not clearly defined
Loans and receivables
Current
Non-Current
Intention to hold to maturity
When will it be matured?
HTM investments
Current
Non-Current
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Measurement

Case

Simple!

Jardines Group *(2003 Annual Report)*

- Other non-current investments which are available for sale are shown at fair value.
- Gains and losses arising from changes in the fair value of non-current investments are dealt with in reserves.
- On the disposal of a non-current investment or when an investment is determined to be impaired, the cumulative gain or loss previously recognized in reserves is included in the consolidated profit and loss account.
- All purchases and sales of investments are recognised on the trade date, which is the date that the Group commits to purchase or sell the investment.

AFS financial assets → **Non-Current**

Measurement

Case

北京控股有限公司
BEIJING ENTERPRISES HOLDINGS LIMITED

Beijing Enterprises Holdings Limited

- Has early adopted all new HKFRS in 2004 Annual Report.
- It clarified the effect on early adopting HKAS 32 and 39 as follows:
  - All long term investments of the Group and the Company as at 31 Dec. 2003 were redesignated into available-for-sale financial assets on 1 Jan. 2004. The aggregate differences between the respective carrying value of each investment as at 31 Dec. 2003 and the respective fair value at 1 Jan. 2004 is insignificant and hence, no adjustment has been made against the retained profits at 1 Jan. 2004.
  - All short term investments of the Group and the Company as at 31 Dec. 2003 were redesignated into financial assets at fair value through profit or loss on 1 Jan. 2004. There is no effect on remeasurement as the accounting policy on measurement of the Group's short term investments as at 31 Dec. 2003 is the same as that for the financial assets at fair value through profit or loss.

Measurement

Case

3 Categories

HKEX

(Consolidated financial statements published on 28 Feb. 2005)

From 1 Jan. 2004, investments of the Group are classified under the following categories:

Financial assets at fair value through profit or loss

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

Available-for-sale financial assets

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

Loans and receivables

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

Measurement

Case

苗圃行動 SOWERS ACTION
中國教育助學計劃 Education Development Program In China

Accounting policy (2003/04) on investments in securities:

- Investments in securities are recognised on a trade-date basis and are initially measured at cost.
- Investments other than held-to-maturity debt securities are classified as investment securities and other investments.
- Investment securities, which are securities held for an identified long-term strategic purpose, are measured at subsequent reporting dates at cost, as reduced by any impairment loss that is other than temporary.
- Other investments are measured at fair value, with unrealised gains or losses included in net profit or loss for the period.

Initially measured at fair value (plus transaction cost) under HKAS 39

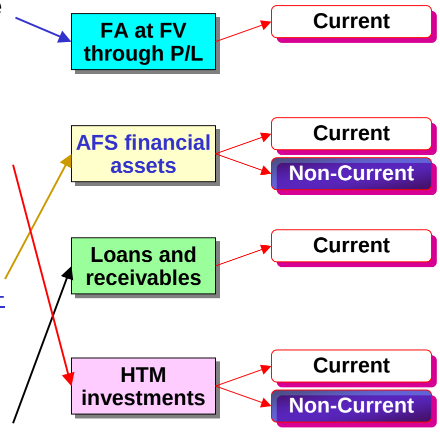
AFS financial assets?

FA at FV through P/L or AFS financial assets?

Measurement – Illustrative Case

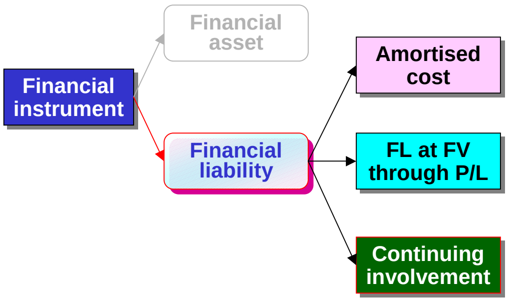
- Financial instruments held for trading are classified as current assets and are stated at fair value, with any resultant gain or loss recognised in the income statement.
- Where the Group has the positive intent and ability to hold government bonds to maturity, they are stated at amortised cost less impairment losses.
- Other financial instruments held by the Group are classified as being available-for-sale and are stated at fair value, with any resultant gain or loss being recognised directly equity ……
- Trading and other receivables are stated at their cost less impairment losses.

KPMG (Nov. 2004)



Financial Liabilities – Measurement

Financial Liabilities – Measurement



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

a) **financial liabilities at fair value through profit or loss**

b) financial liabilities that arise when **a transfer of a financial asset does not qualify for derecognition**, or is accounted for using the **continuing involvement approach**

Financial Liabilities – Measurement

Amortised cost

- Amortised cost
  - As those discussed in financial assets

FL at FV through P/L

- Financial liabilities at fair value through profit or loss
- Similar to financial asset at fair value through profit or loss
  - Those held for trading
    - Acquired principally for selling in the near term
    - Recent actual short-term profit taking
    - Derivatives that are liabilities (except for hedging instruments)
  - Those designated upon initial recognition
- 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

Entity has NO choice

Entity has a choice

Continuing involvement

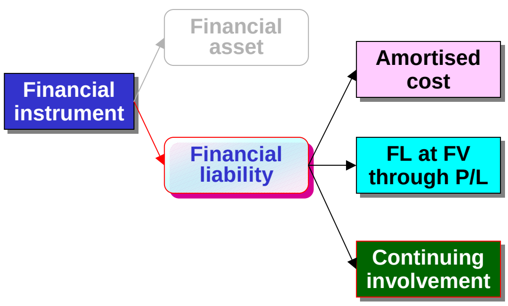
- Financial liabilities that arise when
  - a transfer of a financial asset **does not qualify for derecognition**, or
  - is accounted for using the **Continuing Involvement Approach** (to discuss later)

Financial Liabilities – Measurement

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.

Financial Liabilities – Measurement



Reclassification

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

Implication

- Reclassification is infrequent or rare

Transitional Arrangements

Transitional Arrangements

- Early application is permitted (revised in Nov. 2004)
- At the beginning of the year in which HKAS 39 is initially applied:
  - Classification of financial assets and financial liabilities
    - All assets should apply the criteria in classification and remeasure them in accordance with HKAS 39 accordingly
    - Any adjustment of the previous carrying amount should be recognised as an adjustment of the balance of retained earnings
  - Initial designation
    - Permitted to designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss or available for sale despite the requirement under HKAS 39 to make such designation upon initial recognition
    - For any such financial asset previously designated as available for sale, the entity shall recognise all cumulative changes in fair value in a separate component of equity until subsequent derecognition or impairment

Transitional Arrangements

- Early application is permitted (revised in Nov. 2004)
- At the beginning of the year in which HKAS 39 is initially applied:
  - Held-to-maturity investments
    - Sales or transfers of held-to-maturity investments before the beginning of the year in which HKAS 39 is initially applied do not trigger the "tainting" rules
    - If an entity has sold or transferred held-to-maturity investments previously so designated under SSAP 24 in the two preceding financial years, it is not prevented to continue to classify such financial assets as held-to-maturity investments

Transitional Arrangements – Cases

Case

香港交易所 HKEx

HKEX *(Consolidated financial statements of 28 Feb. 2005)*

- All relevant changes in the accounting policies have been made in accordance with the provisions of the respective standards, which require retrospective application to prior year comparatives other than ……

  HKAS 39:
  - recognise all derivatives at fair value in the balance sheet on 1 January 2004 and adjust the balance to retained earnings;
  - redesignate all investments into available-for-sale financial assets, financial assets at fair value through profit or loss and loans and receivables (which include bank deposits and cash and cash equivalents) on 1 January 2004;
  - remeasure those financial assets or financial liabilities that should be measured at fair value and those that should be measured at amortised cost and adjust the balance to retained earnings at 1 January 2004;
  - prospective application for the derecognition of financial assets.

Transitional Arrangements

Case

Esprit Holdings Limited

- 2004 Annual Report
  - During the years ended June 30, 2004 and 2003, the Group's derivative instruments did not qualify for hedge accounting as the Group was not permitted to retrospectively meet the documentation requirements for hedging under IAS 39

Transitional Arrangements

Case

Your Apparel Supply Chain Services Partner

- In its 2005 Interim Report, full set of HKFRS was adopted and it stated:
  - HKAS 39 – does not permit to recognise, derecognise and measure financial assets and liabilities in accordance with this standard on a retrospective basis.
  - The Group applied the previous SSAP 24 "Accounting for investments in securities" to long term investments for the 2004 comparative information.
  - The adjustments required for the accounting differences between SSAP 24 and HKAS 39 are determined and recognised at 1 January 2005 ……

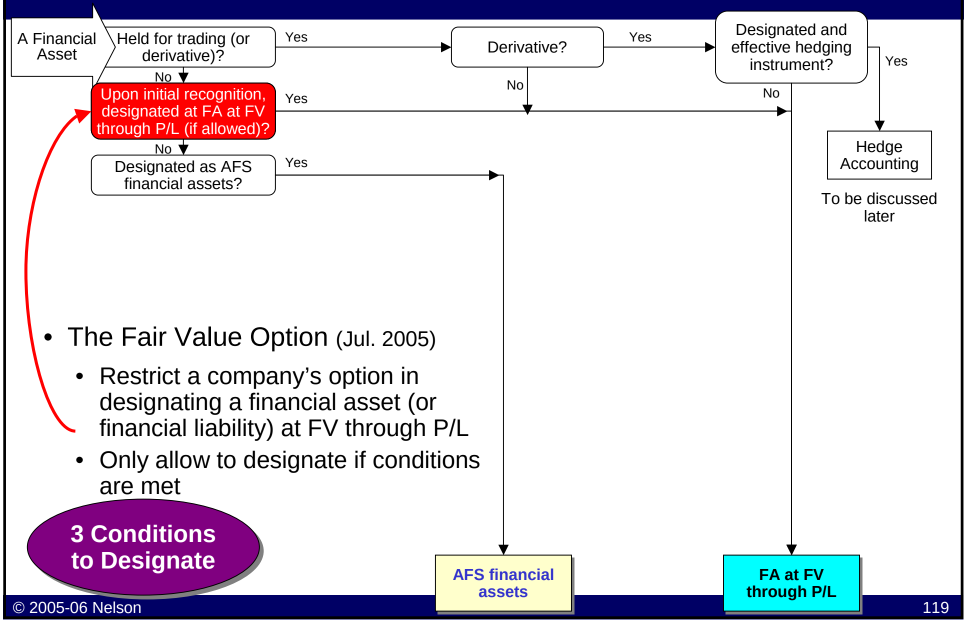
Any more ……

- Complex but main objectives
  - Substance over form
  - Recognition – on balance sheet (reduce off balance sheet items)
  - More detailed disclosures
- Fair value, unless strict rules complied
- Charge to income statement in most cases
- Is it the end ……
  - How many amendments have been issued or are on agenda?

Amendments

Amendments and New Standard issued in 2005	Effective for annual periods beginning on or after
• Transition and Initial Recognition of Financial Assets and Financial Liabilities (Feb. 2005)	➢ 1 Jan. 2005
• Cash Flow Hedge Accounting of Forecast Intragroup Transactions (Jul. 2005)	➢ 1 Jan. 2006
• The Fair Value Option (Jul. 2005)	➢ 1 Jan. 2006
• Financial Instruments: Recognition and Measurement and Insurance Contracts – Financial Guarantee Contracts (Sep. 2005)	➢ 1 Jan. 2006
• HKFRS 7 Financial Instruments: Disclosures (Sep. 2005)	➢ 1 Jan. 2007

Fair Value Option



- The Fair Value Option (Jul. 2005)
  - Restrict a company's option in designating a financial asset (or financial liability) at FV through P/L
  - Only allow to designate if conditions are met

3 Conditions to Designate

Fair Value Option

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 HKAS 39, or
- when doing so results in more relevant information, because either
  - i) it eliminates or significantly reduces a measurement or recognition inconsistency
  - ii) financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis

1. Embedded Derivative Condition

2. Eliminates Inconsistency

3. Managed on Fair Value Basis

3 Conditions to Designate

Fair Value Option

Paragraph 11A of HKAS 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

3 Conditions to Designate

Fair Value Option

- 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

3 Conditions to Designate

Fair Value Option

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

3 Conditions to Designate

Fair Value Option

- 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 HKAS 24)

    e.g. the entity's board of directors and chief executive officer.

3. Managed on Fair Value Basis

3 Conditions to Designate

Fair Value Option

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.
- HKAS 28 *Investments in Associates* and HKAS 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 HKAS 28 or HKAS 31.

3 Conditions to Designate

Fair Value Option

Example

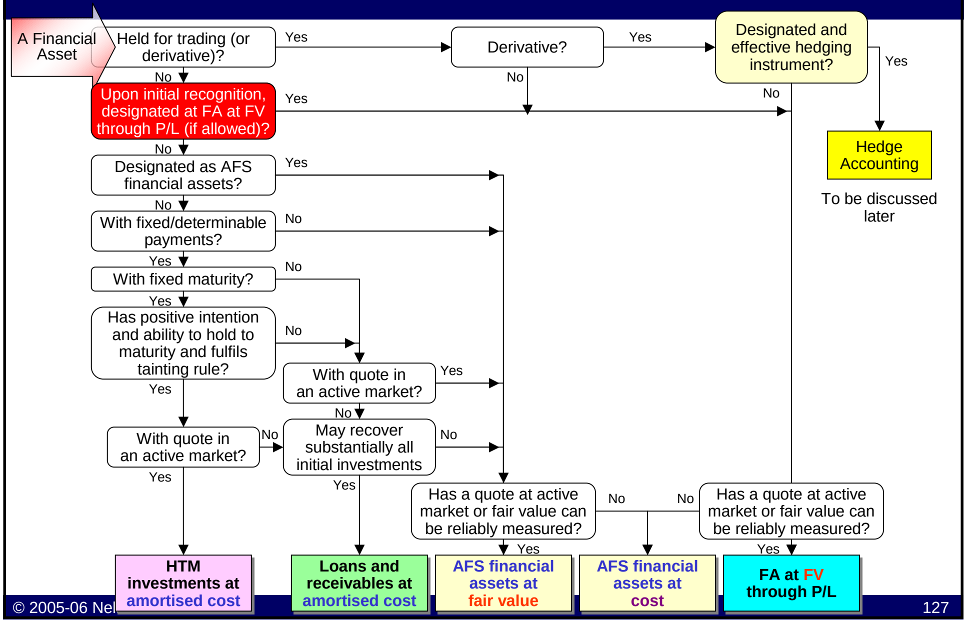
- Entity A has financial assets and financial liabilities that share one or more risks and it
  - originates fixed interest rate loans and
  - manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.
- Those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management.

3. Managed on Fair Value Basis

- The circumstances show when the condition to designate could be met.

3 Conditions to Designate

Fair Value Option



Financial Instrument Standards – Part I

(HKAS 32 and 39) January 2006

Updated slides may be found in
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Financial Instrument Standards – Part I

(HKAS 32 and 39) January 2006

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