Financial Instrument Standards – Part 2

(HKAS 32 and 39) 11 February 2006

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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*.

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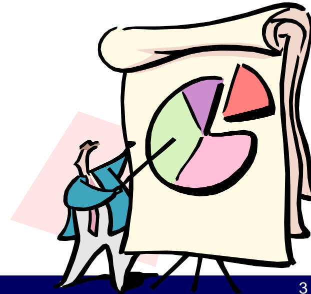
Topics to be discussed

- Recap on recognition and measurement (HKAS 39)
- Definitions of derivatives (HKAS 32 and 39)
- Embedded derivatives (HKAS 39)
- Derecognition (HKAS 39)
- Hedging and hedge accounting (HKAS 39)
- Disclosure and presentation (HKAS 32)
- Transitional arrangement (HKAS 39)

Simple but Comprehensive

Key Issues

Cases and Examples



Mainly from a commercial firm's point of view

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Recap on Recognition & Measurement

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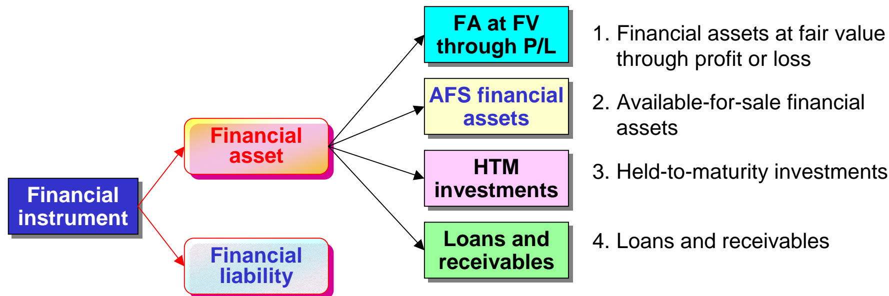
Recap on Recognition & Measurement



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

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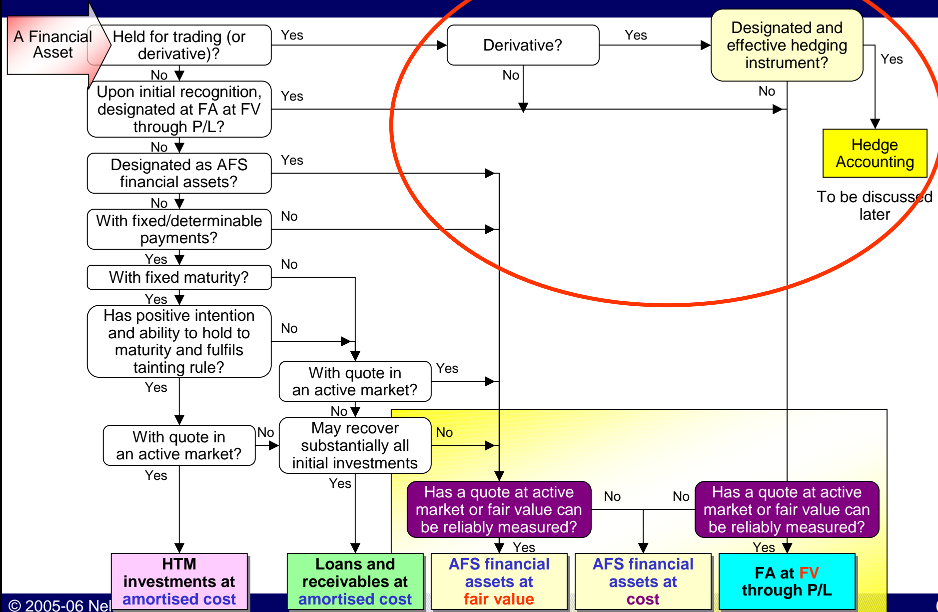
Recap on Recognition & Measurement



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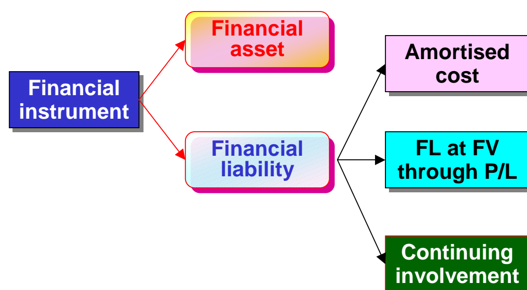
Recap on Recognition & Measurement

	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

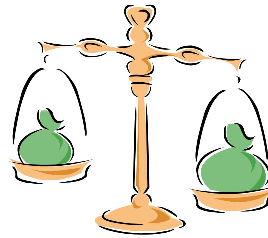
Recap on Recognition & Measurement

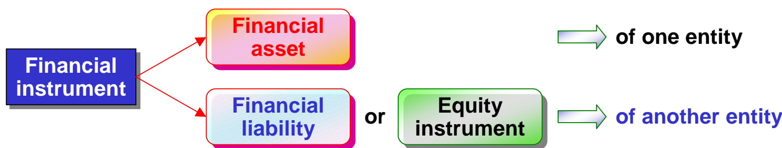


After initial recognition, an entity shall measure all financial liabilities at **amortised cost** using the effective interest method, except for:

- **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**

Definitions – Derivative





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Definitions – Derivative

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

Value change based on an underlying

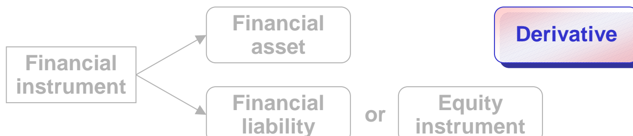
a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying');

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.



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Definitions – Derivative

Example

Derivative

Typical example:
- Future and forward
- Swap and options

Value change based on an underlying

Little or no initial net investment

Settled at a future date

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

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Definitions – Derivative

Example

Value change based on an underlying √

Little or no initial net investment √

Settled at a future date √

2 Non-Derivative Transactions

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

Yes, it meets the definition of a derivative.
- The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment.

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Definitions – Derivative

Example

Value change based on an underlying

Little or no initial net investment

Settled at a future date

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

Definitions – Derivative

Example

Value change based on an underlying √

Little or no initial net investment ×

Settled at a future date √

Prepaid forward

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

No.

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

Definitions – Derivative

Example

Value change based on an underlying √

Little or no initial net investment √

Settled at a future date √

Margin deposit (or account)

- Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts.
- Is the margin account part of the initial net investment?

No!

- The margin account is not part of the initial net investment in a derivative instrument.
- Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets.
- Margin accounts are separate assets that are accounted for separately.

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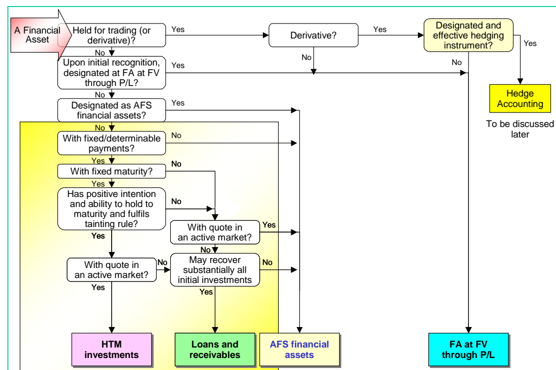
Embedded Derivatives



Will derivative elements in the financial assets affect the classification?

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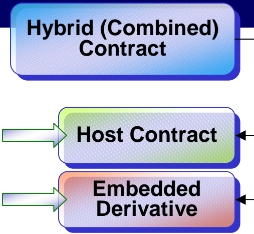
Embedded Derivatives



HKAS 39 introduce Embedded Derivative

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

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

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

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

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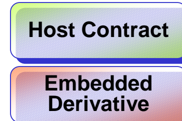
Embedded Derivatives

Example



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

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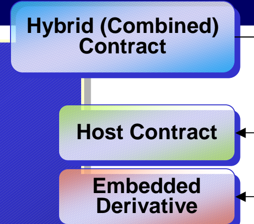
Embedded Derivatives



HKAS 39 requires an embedded derivative

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

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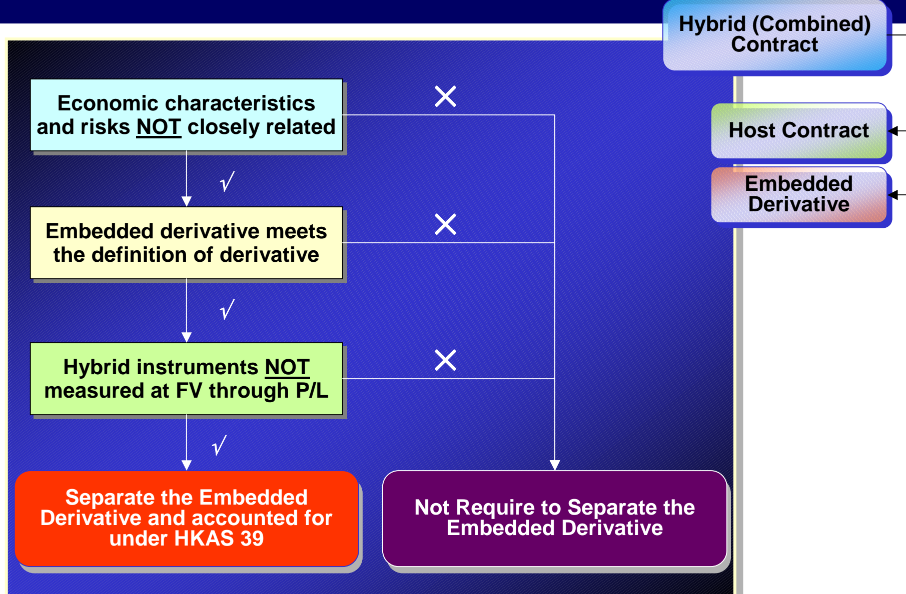
Embedded Derivatives

Hybrid (Combined) Contract
Host Contract
Embedded Derivative



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Embedded Derivatives

If separation is required and can be measured
- ⇒ Host Contract shall be accounted for under applicable HKFRS
- ⇒ Embedded Derivative shall be accounted under HKAS 39 as a derivative

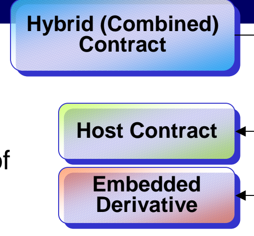
If separation is required but <u>cannot</u> be measured
- ⇒ Entire Hybrid (Combined) Contract is classified as financial instrument that is held for trading

Separate the Embedded Derivative and accounted for under HKAS 39

If separation is not required
- ⇒ Hybrid (combined) contract shall be accounted for under applicable HKFRS

Not Require to Separate the Embedded Derivative

Embedded Derivatives

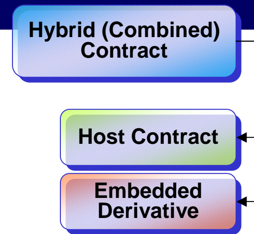


To separate embedded derivative

- An embedded non-option derivative (such as an embedded forward or swap)
  - is separated from its host contract on the basis of its stated or implied substantive terms,
  - so as to result in it having a fair value of zero at initial recognition.
- An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption)
  - is separated from its host contract on the basis of the stated terms of the option feature.
- The initial carrying amount of the host instrument is
  - the residual amount after separating the embedded derivative.

Host Contract = Hybrid (Combined) Contract - Embedded Derivative

Embedded Derivatives



To separate embedded derivative

- If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument)
  - ➢ the fair value of the embedded derivative is the difference between
    - the fair value of the hybrid instrument, and
    - the fair value of the host contract,

    if those can be determined under HKAS 39.

Embedded Derivative = Hybrid (Combined) Contract - Host Contract

- If the entity is still unable to determine the fair value of the embedded derivative using the above method,
  - ➢ the combined instrument is treated as held for trading.

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Embedded Derivatives

Example

Fair value cannot be reliably measured

If an embedded derivative that is required to be separated cannot be reliably measured because it will be settled by an unquoted equity instrument whose fair value cannot be reliably measured, is the embedded derivative measured at cost?

No.

- In this case, the entire combined contract is treated as a financial instrument held for trading.
- If the fair value of the combined instrument can be reliably measured, the combined contract is measured at fair value.
- The entity might conclude, however, that the equity component of the combined instrument may be sufficiently significant to preclude it from obtaining a reliable estimate of the entire instrument.
- In that case, the combined instrument is measured at cost less impairment.

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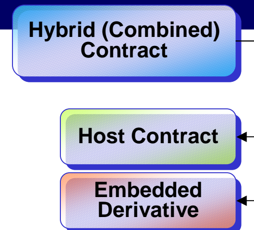
Embedded Derivatives



- Generally, multiple embedded derivatives in a single instrument are treated as
  - ➢ a single compound embedded derivative
- However, embedded derivatives that are classified as equity
  - ➢ are accounted for separately from those classified as assets or liabilities (see HKAS 32, to be discussed later)
- In addition, if an instrument has more than one embedded derivative and those derivatives
  - relate to different risk exposures and
  - are readily separable and independent of each other
  - ➢ they are accounted for separately from each other

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Embedded Derivatives

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?

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Embedded Derivatives

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.

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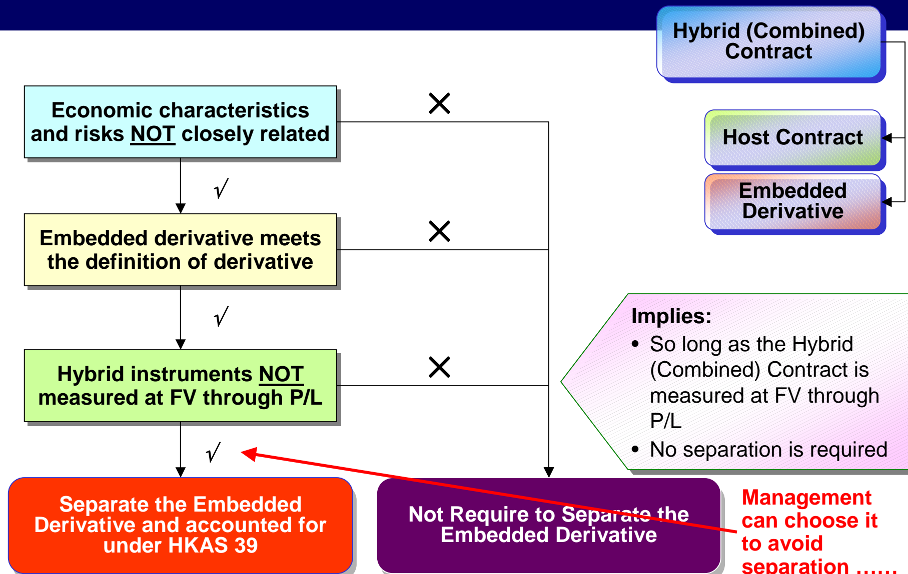
Embedded Derivatives



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Embedded Derivatives

Case

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

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

Financial assets at fair value through profit or loss

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

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

Available-for-sale financial assets

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

Loans and receivables

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

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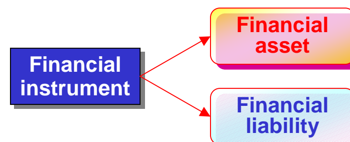
Derecognition



Derecognition of Financial Assets

An entity shall derecognise a **financial asset** when, and only when:

a) the contractual rights to the cash flows from the financial asset expire; or

b) it transfers the financial asset, and the transfer qualifies for derecognition

- Direct derecognition
- Further Test 1: Asset Transfer Test
- Further Test 2: Risk and Reward Test

General principles

- **If passing both Further Tests** ⇒ **derecognise the asset**
- **If not passing Asset Transfer Test** ⇒ **not derecognise the asset**
- **If passing the Asset Transfer Test, but not passing Risk and Reward test** ⇒ **consider the entity's control over the asset, and extent of continuing involvement**

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Derecognition of Financial Assets

Consolidate all subsidiaries (including any SPE) [Para. 15]

Determine whether the derecognition principles below are applied to a part or all of an asset (or group of similar assets) [Para. 16]

- In consolidated financial statements, the detailed derecognition principles are applied at a consolidated level.
- Hence, an entity first consolidates all subsidiaries in accordance with HKAS 27 (including Interpretation on Special Purpose Entities) and then applies the detailed derecognition principles to the resulting group.
- Before evaluating whether, and to what extent, detailed derecognition principles under HKAS 39 is appropriate, an entity determines whether such principles should be applied to
  - a part of a financial asset (or a part of a group of similar financial assets) or
  - a financial asset (or a group of similar financial assets) in its entirety

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Derecognition of Financial Assets

Example

AB holds a bond, which has

Interest Payment 1

Interest Payment 2

Principal Payment

Determine whether the derecognition principles below are applied to a part or all of an asset (or group of similar assets) [Para. 16]

Detailed derecognition principles are applied to

- a part of a financial asset (or a part of a group of similar financial assets) if, and only if
- the part being considered for derecognition meets any one of the following three conditions, that the part comprises:
  - i) only specifically identified cash flows from a financial asset
  - ii) only a fully proportionate (pro rata) share of the cash flows from a financial asset
  - iii) only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset

Interest rate strip – AB transfer only
Interest Payment 1

AB transfer 90% of all cash flows of the bond

AB transfer 90%
Interest Payment 1

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Derecognition of Financial Assets

Consolidate all subsidiaries (including any SPE) [Para. 15]

Determine whether the derecognition principles below are applied to a part or all of an asset (or group of similar assets) [Para. 16]

Have the rights to the cash flows from the asset expired? [Para. 17(a)] → Yes → Derecognise the asset

An entity shall derecognise a financial asset when, and only when:

a) the contractual rights to the cash flows from the financial asset expire; or

b) it transfers the financial asset, and the transfer qualifies for derecognition

Direct derecognition

Further Test 1: Asset Transfer Test

Further Test 2: Risk and Reward Test

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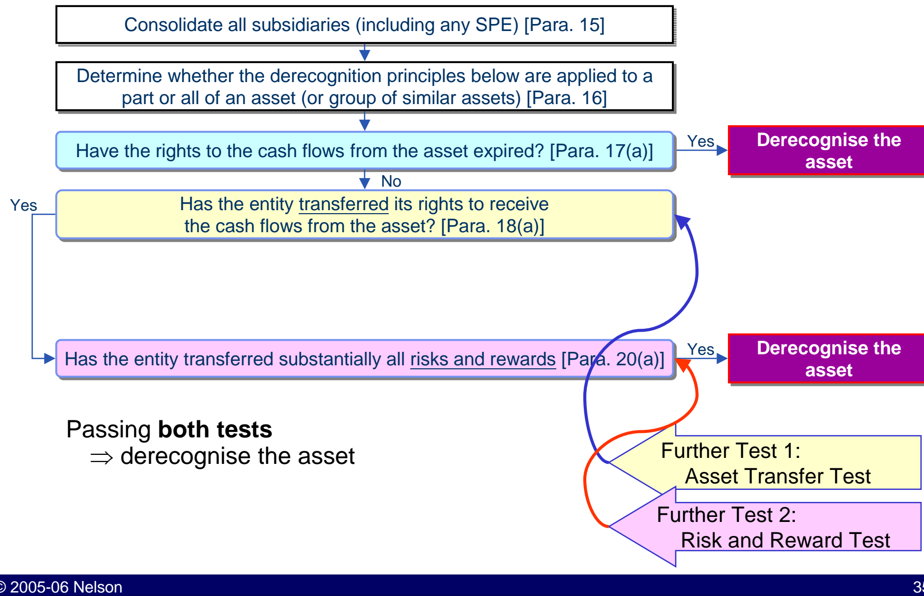
Derecognition of Financial Assets



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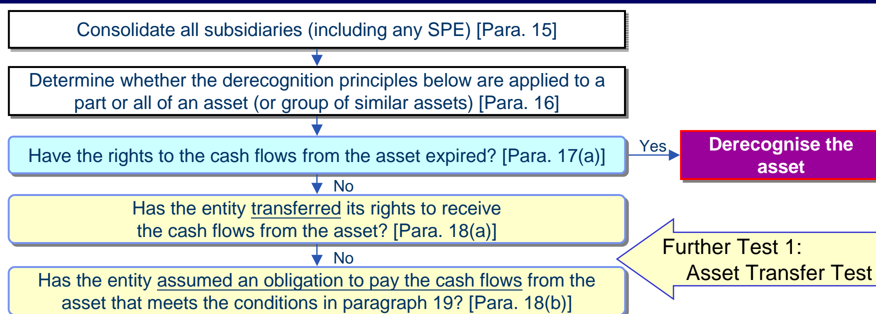
Derecognition of Financial Assets



Passing the **Asset Transfer Test**, if the contractual rights to receive the asset's cash flows are:

a) Transferred (i.e. sell the asset), or
b) Retained but assume a contractual obligation to pay the asset's cash flows that meet the following 3 conditions:
- No obligation to pay unless the original asset's cash inflow is received
- Prohibited from selling or pledging the original asset
- Obligated to remit any cash inflows received without material delays

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Derecognition of Financial Assets

Example

Has the entity assumed an obligation to pay the cash flows from the asset that meets the conditions in paragraph 19? [Para. 18(b)]

- If the entity is a special purpose entity or trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets.
  - In that case, the financial assets qualify for derecognition if the conditions under HKAS 39 are met.
- The originator of the financial asset, or it could be a group, that includes a consolidated special purpose entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

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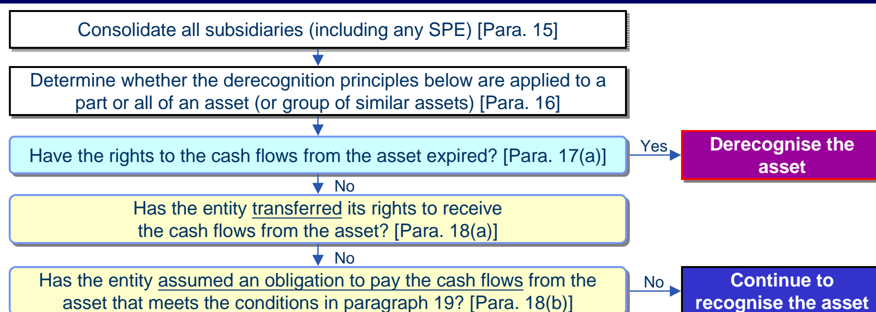
Derecognition of Financial Assets



Not passing **Asset Transfer Test**
⇒ continue to recognise the asset

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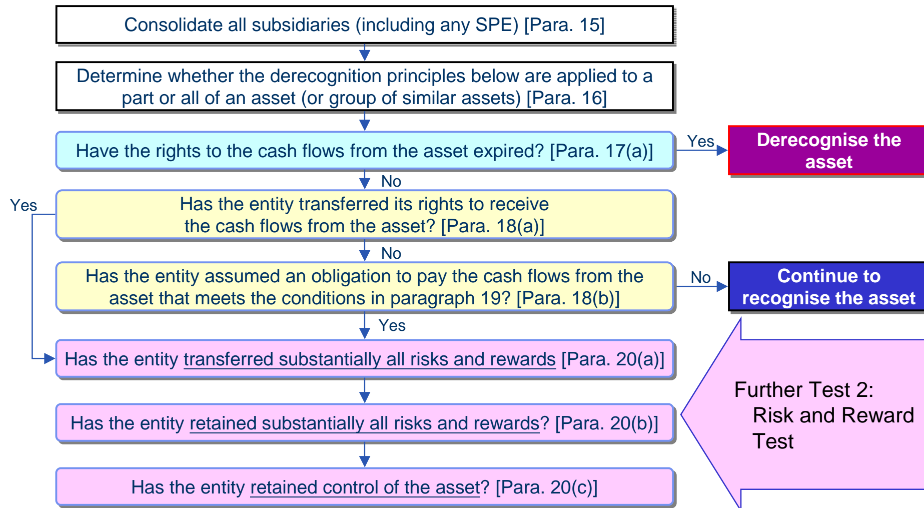
Derecognition of Financial Assets



Derecognition of Financial Assets

The transfer of risks and rewards is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset:

- If such exposure does not change significantly
  - Retained substantially
- If such exposure is no longer significant
  - Transferred substantially

Has the entity transferred substantially all risks and rewards [Para. 20(a)]

Has the entity retained substantially all risks and rewards? [Para. 20(b)]

Derecognition of Financial Assets

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).

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

Has the entity transferred substantially all risks and rewards [Para. 20(a)]

Has the entity retained substantially all risks and rewards? [Para. 20(b)]

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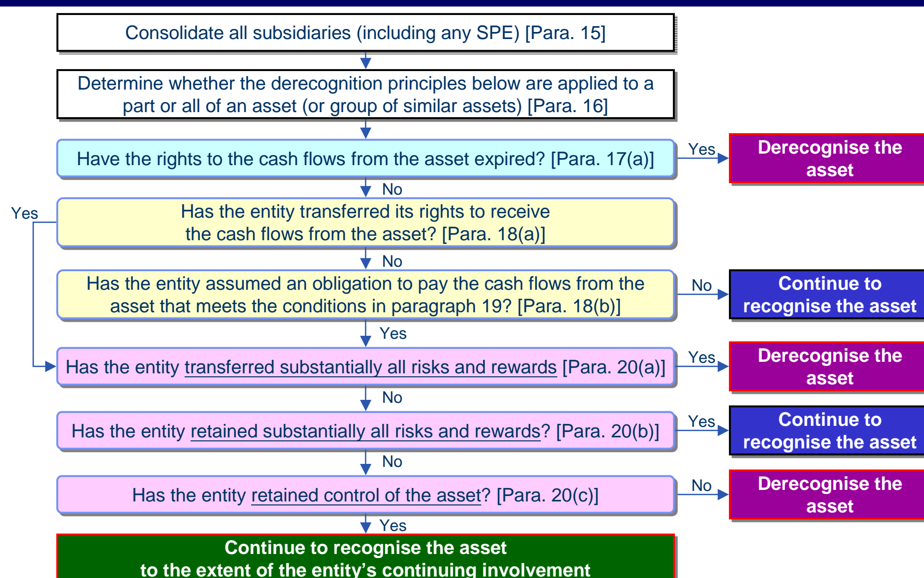


Derecognition of Financial Assets

- Remember ….. a regular way purchase or sale of financial assets shall be recognised (and derecognised) using
  - trade date accounting, or
  - settlement date accounting
- On derecognition of a financial asset in its entirety, the difference between:
  a) the carrying amount and
  b) the sum of
     i) the consideration received (including any new asset obtained less any new liability assumed) and
     ii) any cumulative gain or loss that had been recognised directly in equity

  shall be recognised in profit or loss.
- The gain or loss resulted from other forms of derecognition should be examined case by case.

Derecognise the asset

Derecognise the asset

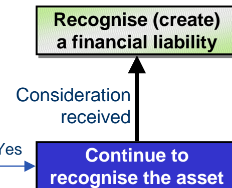
Derecognise the asset

Derecognition of Financial Assets

- If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall
  - continue to recognise the transferred asset in its entirety
  - recognise a financial liability for the consideration received
  - in subsequent periods, recognise
    - any income on the transferred asset and
    - any expense incurred on the financial liability.

Has the entity retained substantially all risks and rewards? [Para. 20(b)]

Yes



Derecognition of Financial Assets

Continuing Involvement Approach

- If an entity
  - neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and
  - retains control of the transferred asset,
    - ➢ the entity continues to recognise the transferred asset to the extent of its continuing involvement.
- The extent of the entity's continuing involvement in the transferred asset is
  - ➢ the extent to which it is exposed to changes in the value of the transferred asset.

Has the entity retained substantially all risks and rewards? [Para. 20(b)]

↓ No

Has the entity retained control of the asset? [Para. 20(c)]

↓ Yes

Continue to recognise the asset to the extent of the entity's continuing involvement

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Derecognition of Financial Assets

Example

Continuing Involvement Approach

1. By guaranteeing the transferred asset
   - ➢ the extent of the entity's continuing involvement is the lower of
     - i) the amount of the asset and
     - ii) the guarantee amount, i.e. the maximum amount of the consideration received that the entity could be required to repay
2. By a written or purchased option (or both) on the transferred asset
   - ➢ the extent of the entity's continuing involvement is
     - In case of option NOT measured at fair value
       - ➢ the amount of the transferred asset that the entity may repurchase.
     - In case of option measured at fair value
       - ➢ limited to the lower of
         - the fair value of the transferred asset and
         - the option exercise price.

Continue to recognise the asset to the extent of the entity's continuing involvement → **Associated liability**

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Derecognition of Financial Assets

Continuing Involvement Approach

- The entity also recognises an associated liability
- Both transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained (despite other measurement requirements in HKAS 39)
- The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is,
  a) if the transferred asset is measured at amortised cost
     - the amortised cost of the rights and obligations retained by the entity; or
  b) if the transferred asset is measured at fair value
     - equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis.
- The entity shall continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and shall recognise any expense incurred on the associated liability.

Continue to recognise the asset to the extent of the entity's continuing involvement → **Associated liability**

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Derecognition of Financial Assets

Continuing Involvement Approach

- If a transferred asset continues to be recognised, the asset and the associated liability shall not be offset.
- Similarly, the entity shall not offset any income arising from the transferred asset with any expense incurred on the associated liability

Continue to recognise the asset to the extent of the entity's continuing involvement → **Associated liability**

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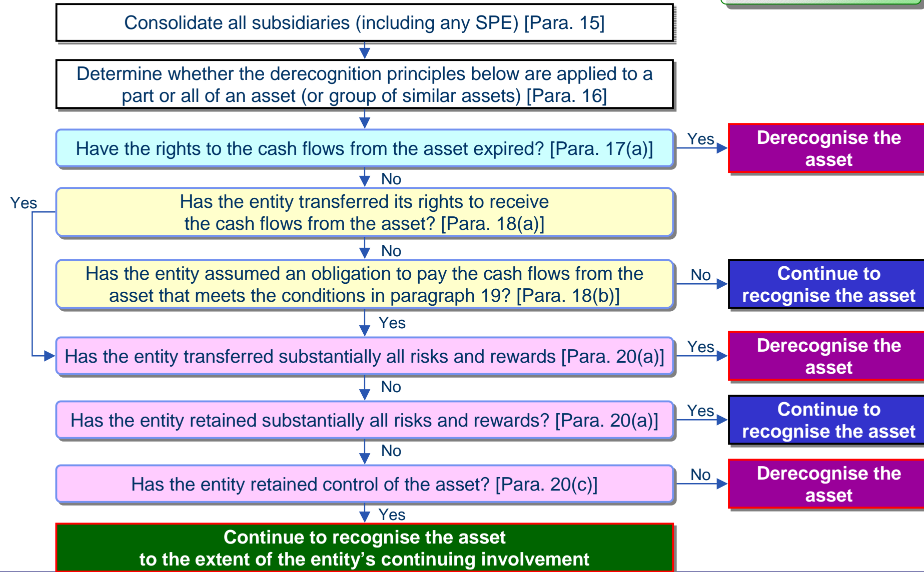
Derecognition of Financial Assets

Example

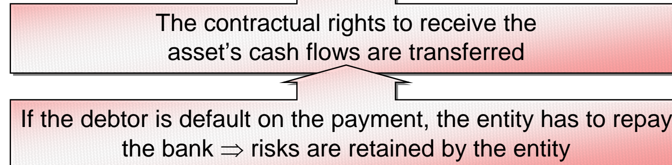


Derecognition of Financial Assets

Example

For SMEs/SMPs ⇒ say Discounted Bills, Factored Trade Receivables
For larger entities ⇒ say Strip and Total return swap

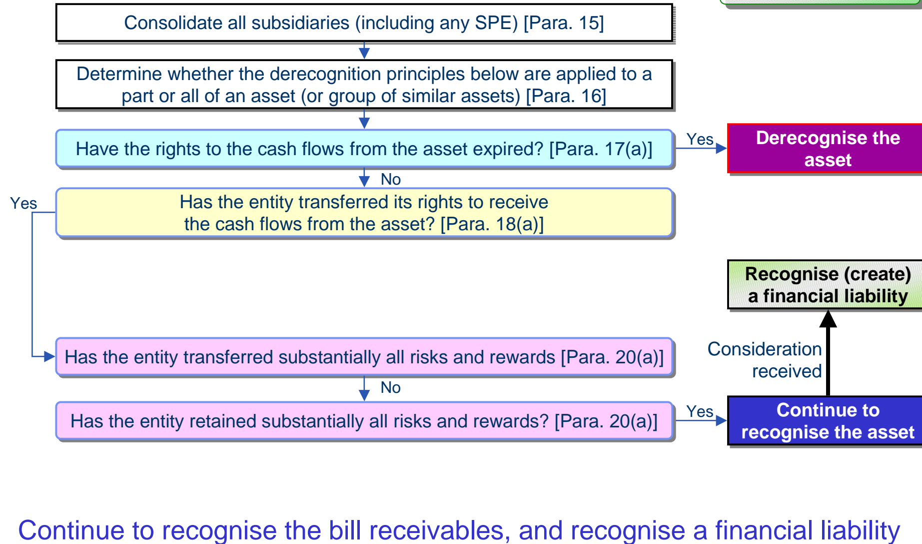
Let's analyse a bill discounted to bank
⇒ At present, most entities derecognise bill receivable discounted to bank and disclose it as contingent liability
⇒ Is it appropriate under new derecognition criteria?



Continue to recognise the bill receivables, and recognise a financial liability

Derecognition of Financial Assets

Example



Continue to recognise the bill receivables, and recognise a financial liability

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Derecognition of Financial Assets

Example

- Entity A sells receivables to Entity B.
- The receivables, which are due in 6 months and have a carrying value of $100,000 are sold for a cash payment of $95,000 subject to full recourse.
- Under the right of recourse, Entity A is obligated to compensate Entity B for the failure of the debtors to pay when due.
- In addition to the recourse, Entity B is entitled to sell the receivables back to Entity A in the event of unfavourable changes in interest rates or the credit ratings of the underlying debtors.
- How should the transaction be accounted for?

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Derecognition of Financial Assets

Example

- The transaction is accounted for by Entity A as a secured loan as it does not qualify for derecognition.
- Because Entity A has retained substantially all of the risks associated with the assets.
- Although Entity B has the ability to sell or pledge approximately the full value of the assets transferred, Entity A has granted Entity B a put option on the transferred assets allowing Entity B to sell the receivables back to Entity A in the event of actual credit losses and changes in underlying credit ratings or interest rates.
- Consequently Entity A is regarded as having retained substantially all the risks of ownership of the receivables.
- Entity A recognises $95,000 as a liability. The liability is measured at amortised cost with an interest expense of $5,000 being recognised over the 6-month period until maturity.
- Entity A continues to recognise the receivables as assets.
- Cash received on the receivables by either Entity A or Entity B reduces both the receivables and the liability.
- If uncollected receivables are returned to Entity A for cash, the liability is reduced and an impairment loss recognised if not previously recognised by the transferor.

Derecognition of Financial Assets

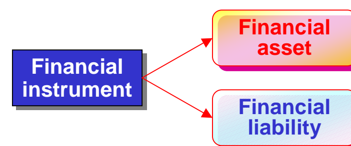
Case

- In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:
  - the Group's discounted bills with recourse,
    - which were previously treated as contingent liabilities,
    - have been accounted for as collateralized bank advances prospectively on or after 1 January 2005,
    - as the financial asset derecognition conditions as stipulated in HKAS 39 have not been fulfilled.

Total advances recognised:	HK$ 822M
Current liabilities of that date:	7,578M
Net current assets of that date:	1,229M

Derecognition of Financial Assets

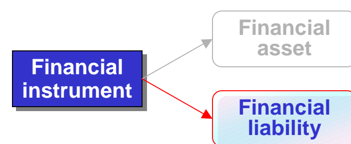
Example



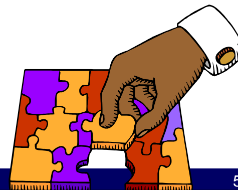
Derecognition of Financial Liabilities

- An entity shall derecognise a financial liability (or part of a financial liability) when, and only when, it is extinguished
  i.e. obligation discharged or cancelled or expires
- An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as
  - an extinguishment of the original financial liability and
  - the recognition of a **NEW** financial liability.
- Similar accounting treatment is adopted for a substantial modification of the terms of an existing financial liability or a part of it
- The difference between
  - the carrying amount of a financial liability extinguished or transferred to another party and
  - the consideration paid, including any non-cash assets transferred or liabilities assumed

  shall be recognised in profit or loss.



Hedging and Hedge Accounting



Hedging – Introduction

A Hedge under HKAS 39 involves 2 components

- Strict conditions must be fulfilled before **Hedge Accounting** can be used.
- But even qualified, an entity can also choose not to use it, but ……

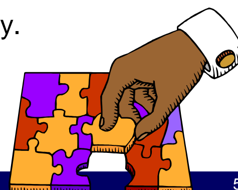
Hedging Instrument

Hedged Item

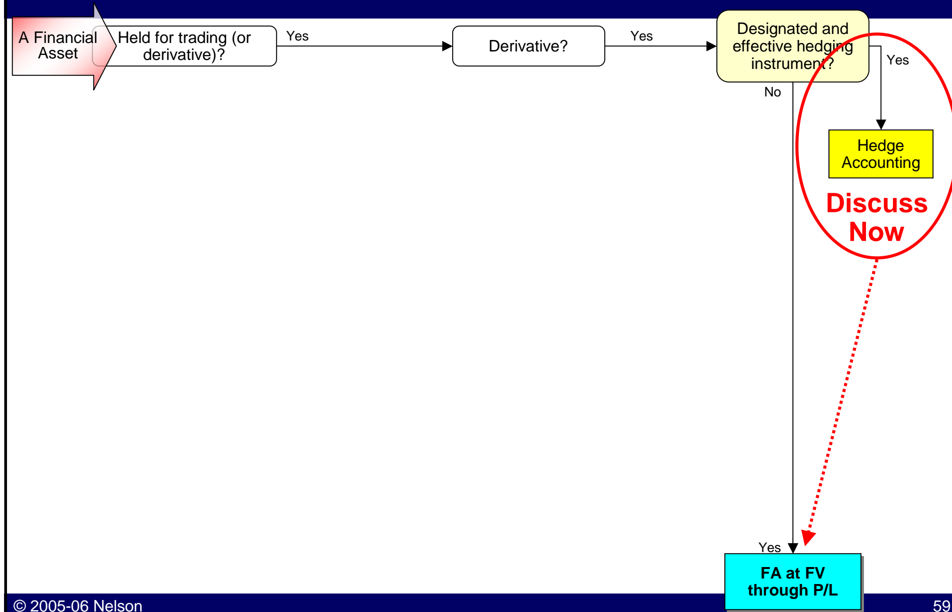
HKAS 39 sets out **Hedge Accounting** which recognises the offsetting effects on profit or loss of changes in the fair values of these 2 components.

Hedge Accounting seeks to match the 2 sides of a **Hedging Relationship**, so as

- to ensure both sides are offset and
- not to affect the income statements from one side only.



Hedging – Introduction



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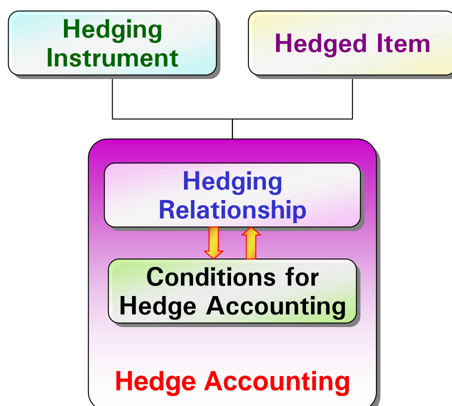
Hedging – Introduction



HKAS 39

- defines and restricts the items qualified as
  - **Hedging Instruments** and
  - **Hedged Items**
- Sets out the types of **Hedge Relationship**
- Requires **Conditions for Hedging Accounting** must be fulfilled to qualify a hedge accounting
- Sets out the **Hedge Accounting**

If there is a designated **Hedging Relationship**, accounting for gain or loss on the **Hedging Instruments** and **Hedged Item** shall follow **Hedge Accounting**.

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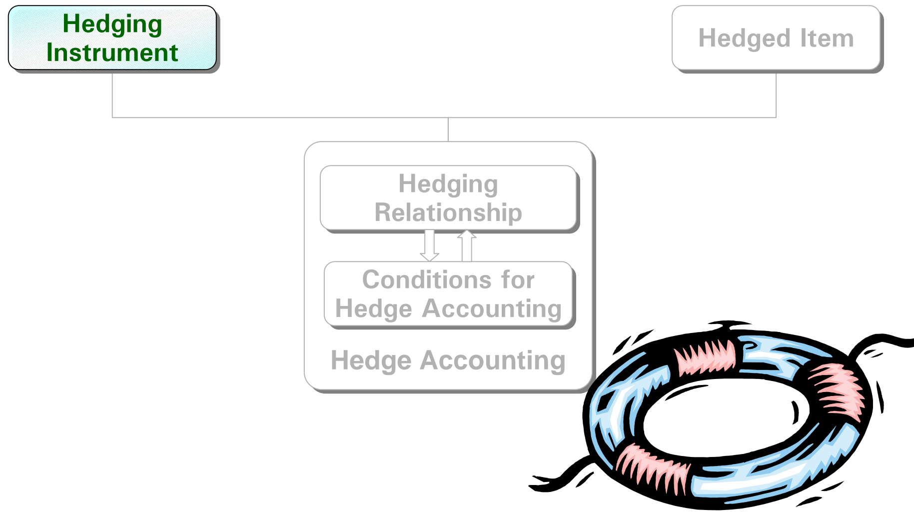
Hedging – Hedging Instruments
Hedging Instrument
Hedged Item
Hedging Relationship
Conditions for Hedge Accounting
Hedge Accounting
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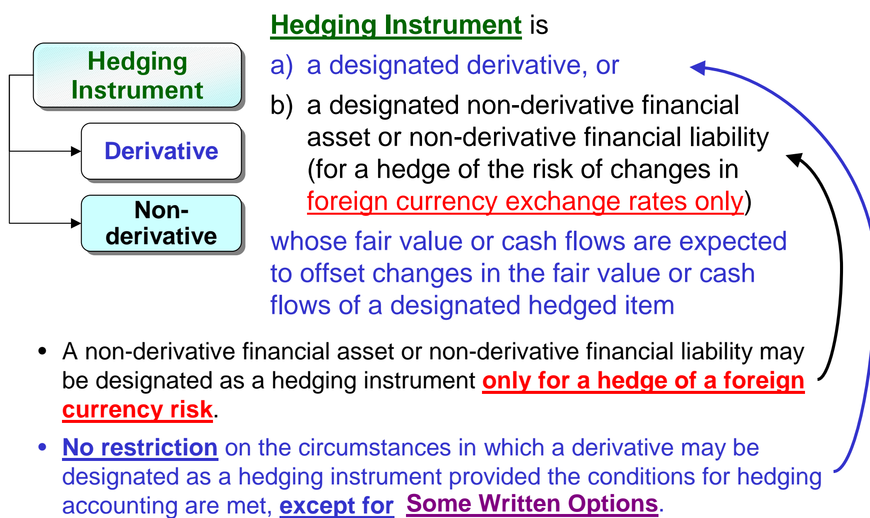
61


Hedging – Hedging Instruments
Hedging Instrument
Derivative
Non-derivative
Hedging Instrument is
a) a designated derivative, or
b) a designated non-derivative financial asset or non-derivative financial liability (for a hedge of the risk of changes in foreign currency exchange rates only)
whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item
• A non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of a foreign currency risk.
• No restriction on the circumstances in which a derivative may be designated as a hedging instrument provided the conditions for hedging accounting are met, except for Some Written Options.
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62

Hedging – Hedging Instruments

Hedging Instrument
Derivative

Derivatives as Hedging Instruments

- Include forward, futures, option contract, swap contracts
- But **Some Written Options** not qualified as hedging instruments
  - Since the potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item.
    - a written option is **not effective** in reducing the profit or loss exposure of a hedged item.
    - a written option does not qualify as a hedging instrument unless it is designated as an offset to a **purchased option**
- In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows.
- Accordingly, purchased option can qualify as a hedging instrument.

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Hedging – Hedging Instruments

Hedging Instrument
Non-derivative

Non-derivative financial asset or non-derivative financial liability

- Can be designated as a hedging instrument but only for a hedge of foreign currency risk
- Including
  - held-to-maturity investment carried at amortised cost
- Excluding
  - investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured
  - derivative that is linked to and must be settled by delivery of the above unquoted equity instrument
  - an entity's own equity instruments, which are not financial assets or financial liabilities of the entity

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Hedging – Hedging Instruments

Example

Entity A, whose functional currency is the Japanese yen

- has issued 5 million 5-year US$ fixed rate debt.
- owns a 5 million 5-year US$ fixed rate bond which is classified as AFS.

1. Can Entity A designate its US$ liability as a hedging instrument in a fair value hedge of the entire fair value exposure of its US$ bond?
2. Alternatively, can the US$ liability be designated as a fair value hedge or cash flow hedge of the foreign currency component of the bond?

1. No.
   - HKAS 39 permits a non-derivative to be used as a hedging instrument only for a hedge of a foreign currency risk.
   - Entity A's bond has a fair value exposure to:
     - foreign currency risk, interest rate changes and credit risk.
2. Yes
   - However, hedge accounting is unnecessary because the amortised cost of the hedging instrument and the hedged item are both remeasured using closing rates.

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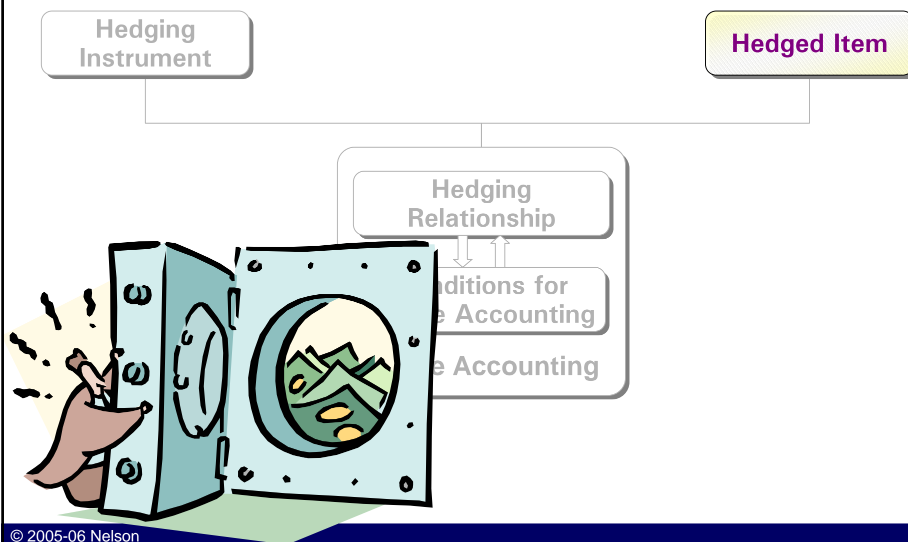
Hedging – Hedged Item



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Hedging – Hedged Item

Hedged Item

Hedged item is
- an asset,
- a liability,
- a firm commitment,
- a highly probable forecast transaction, or
- a net investment in a foreign operation, that

exposes the entity to risk of changes in fair value or future cash flows and is designated as being hedged.

- A hedged item is an exposure to risk to an entity that attempt to hedge.
- A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation.

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Hedging – Hedged Item

Example

- Is hedge accounting permitted for a currency borrowing that hedges an expected but not contractual revenue stream in foreign currency?

Yes, if the revenues are highly probable.
- Under HKAS 39, a hedge of an anticipated sale (highly probable forecast transaction) may qualify as a Cash Flow Hedge.
- For example:
  - An airline entity may use sophisticated models based on experience and economic data to project its revenues in various currencies.
  - If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are "highly probable", as required by HKAS 39, it may designate a currency borrowing as a Cash Flow Hedge of the future revenue stream.
  - It is unlikely that it can reliably predict 100% revenues for a future year.
  - However, it is possible that a portion of predicted revenues, normally those expected in the short term, will meet the "highly probable" criterion.

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Hedging – Hedged Item

Example

- Entity A forecasts that it will issue equity instruments or declare dividend payments to shareholders next month in a foreign currency.
- Can it designated such forecast transactions as Hedged Item?

No.

- To qualify as a Hedged Item, the forecast transaction must expose the entity to a particular risk that can affect profit or loss.
- The classification of financial instruments as liabilities or equity generally provides the basis for determining whether transactions or other payments relating to such instruments are recognised in profit or loss.
  - For example, distributions to holders of an equity instrument are debited by the issuer directly to equity. Therefore, such distributions cannot be designated as a Hedged Item.
- However, a declared dividend that has not yet been paid and is recognised as a financial liability may qualify as a Hedged Item.
  - for example, for foreign currency risk if it is denominated in a foreign currency.

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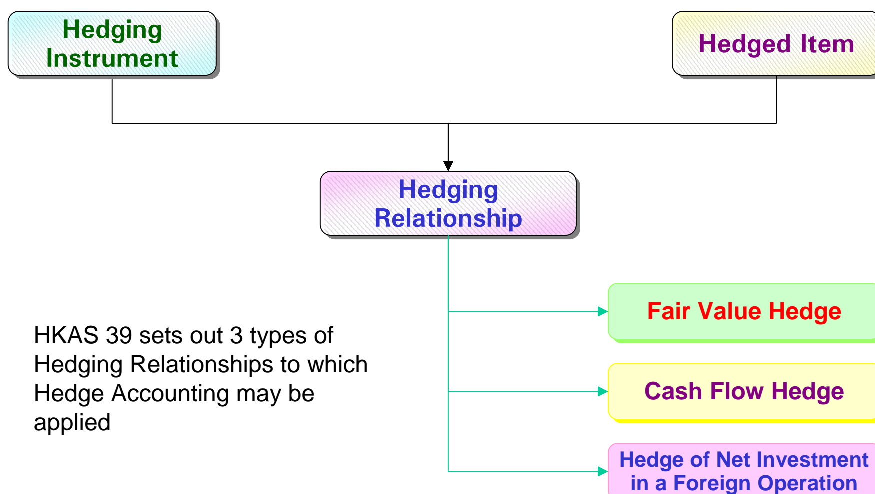
Hedging – Hedged Relationship



HKAS 39 sets out 3 types of Hedging Relationships to which Hedge Accounting may be applied

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Hedging – Hedged Relationship

Fair Value Hedge

e.g. a hedge of exposure to changes in the fair value of a fixed rate bond as a result of changes in interest rates

A hedge of the exposure to changes in fair value of
- a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such items

that is attributable to a particular risk and could affect P/L

Cash Flow Hedge

e.g. the use of a swap to change a floating rate bond to a fixed rate bond

A hedge of the exposure to variability in cash flows that
i) is attributable to a particular risk associated with a recognised asset or liability, or a highly probable forecast transaction and
ii) could affect profit or loss

A hedge of the foreign currency risk of a firm commitment may be accounted for
- as a fair value hedge or as a cash flow hedge

Hedge of Net Investment in a Foreign Operation

Hedge of a net investment in a foreign operation is as defined in HKAS 21 *The Effects of Changes in Foreign Exchange Rates*

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Hedging – Hedged Relationship

Example

- Entity X issues a fixed-rate debt instrument.
- It also enters into a receive-fixed, pay-variable interest rate swap to offset the exposure to interest rate risk associated with the above debt instrument.
- Can Entity X designate the swap as a Cash Flow Hedge of the future interest cash outflows associated with the debt instrument?

No.
- HKAS 39 states that a Cash Flow Hedge is "a hedge of the exposure to variability in cash flows".
- In this case, the issued debt instrument does not give rise to any exposure to variability in cash flows since the interest payments are fixed.
- The entity may designate the swap as a Fair Value Hedge of the debt instrument, but it cannot designate the swap as a Cash Flow Hedge of the future cash outflows of the debt instrument.

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Hedging – Hedged Relationship

Example

- **Company 2066** has a foreign currency liability payable in 6 months' time.
- It wishes to hedge the amount payable on settlement against foreign currency fluctuations.
- To that end, it takes out a forward contract to buy the foreign currency in 6 months' time.
- Should the hedge be treated as:
  a) Fair Value Hedge of the foreign currency liability with gains and losses on revaluing the liability and the forward contract at the year-end both recognised in the income statement; or
  b) Cash Flow Hedge of the amount to be settled in the future with gains and losses on revaluing the forward contract recognised in equity?

- HKAS 39 does not preclude either of these 2 methods.
  (Hedge Accounting to be discussed later)

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Hedging

Case

ESPRIT

Esprit Holdings Limited

- Accounting policy on derivative financial instruments
  – The method of recognising the resulting gain or loss where the derivative is designated as a hedging instrument depends on the nature of the item being hedged.
  – The Group can designate certain derivatives as either:
    i) hedges of the fair value of recognised assets or liabilities or a firm commitment (**Fair Value Hedges**); or
    ii) hedges of highly probable forecast transactions (**Cash Flow Hedges**).

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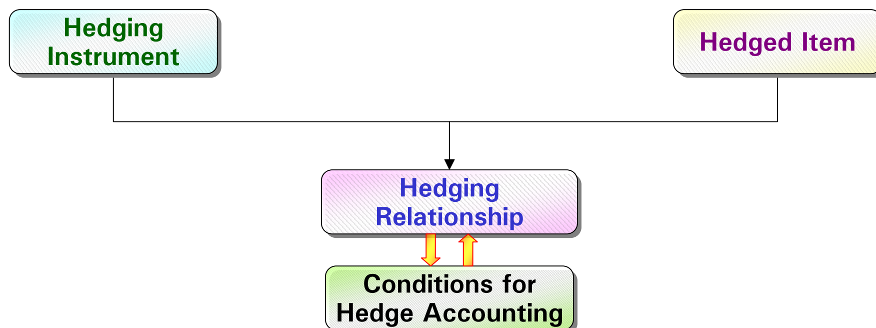
Hedging – Hedge Accounting Conditions



A **Hedging Relationship** qualifies for **Hedge Accounting** if and only if all the **Conditions for Hedge Accounting** are met

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Hedging – Hedge Accounting Conditions

All **Conditions for Hedge Accounting** must be met:

a) At the inception of the hedge, there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. *(including identification of Hedging Instrument and Hedged Item, the nature of the risk being hedged, and how hedging effectiveness be assessed)*

b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

c) For Cash Flow Hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

d) The effectiveness of the hedge can be reliably measured, i.e. the fair value or cash flows of the Hedged Item that are attributable to the hedged risk and the fair value of the Hedging Instrument can be reliably measured.

e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

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Hedging – Hedge Accounting Conditions

- **Hedge effectiveness** is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.
- A hedge is regarded as **highly effective** only if both of the following conditions are met:
  a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated.
  b) The actual results of the hedge are within a range of 80% – 125%.
- Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial statements.

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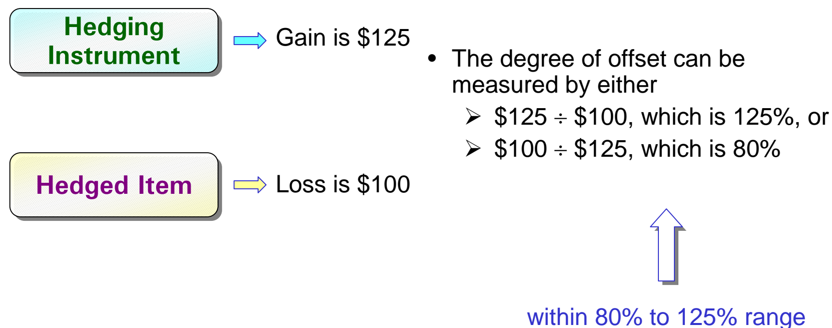
Hedging – Hedge Accounting Conditions

Example

Hedge Effectiveness



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Hedging – Hedge Accounting Conditions

Example

- If the principal terms of the Hedging Instrument and of the entire hedged asset or liability or hedged forecast transaction are the same, can an entity assume perfect hedge effectiveness without further effectiveness testing?

No.

- HKAS 39 requires an entity to assess hedges on an ongoing basis for hedge effectiveness.
- It cannot assume hedge effectiveness even if the principal terms of the hedging instrument and the hedged item are the same, since hedge ineffectiveness may arise because of other attributes such as the liquidity of the instruments or their credit risk.
- It may, however, designate only certain risks in an overall exposure as being hedged and thereby improve the effectiveness of the hedging relationship.
- For example, for a Fair Value Hedge of a debt instrument, if the derivative hedging instrument has a credit risk that is equivalent to the AA-rate, it may designate only the risk related to AA-rated interest rate movements as being hedged, in which case changes in credit spreads generally will not affect the effectiveness of the hedge

Hedging – Hedge Accounting Conditions

Example

- HKAS 39 requires that the hedge is expected to be highly effective.
- Should expected hedge effectiveness be assessed separately for each period or cumulatively over the life of the hedging relationship?

- Expected hedge effectiveness may be assessed on a cumulative basis if the hedge is so designated, and that condition is incorporated into the appropriate hedging documentation.
- Then, even if a hedge is not expected to be highly effective in a particular period, hedge accounting is not precluded if effectiveness is expected to remain sufficiently high over the life of the hedging relationship.
- However, any ineffectiveness is required to be recognised in profit or loss as it occurs.

Hedging – Hedge Accounting Conditions

Example

- HKAS 39 requires that the hedge is expected to be highly effective.
- Should expected hedge effectiveness be assessed separately for each period or cumulatively over the life of the hedging relationship?

- To illustrate:
  - Entity A designates a LIBOR-based interest rate swap as a hedge of a borrowing whose interest rate is a UK base rate plus a margin.
  - The UK base rate changes, perhaps, once each quarter or less, in increments of 25-50 basis points, while LIBOR changes daily.
  - Over a period of 1-2 years, the hedge is expected to be almost perfect.
  - However, there will be quarters when the UK base rate does not change at all, while LIBOR has changed significantly.
  - This would not necessarily preclude hedge accounting.

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Hedging – Case

Case

Esprit Holdings Limited

- Accounting policy on derivative financial instruments
  - The Group is required to document at the inception of the transaction the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions.
  - The Group is also required to document its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

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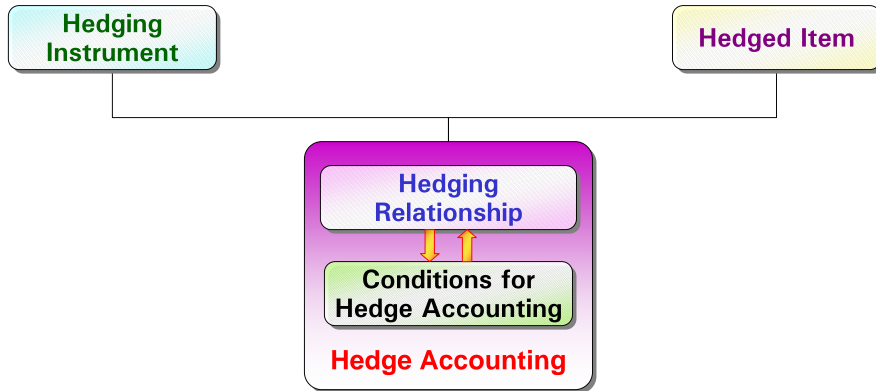
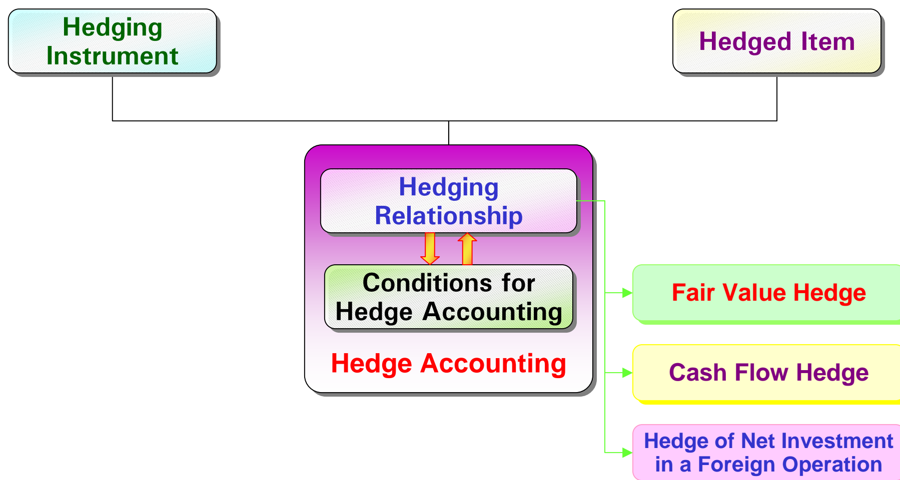
Hedging – Hedge Accounting



If a **Hedging Relationship** meets all the **Conditions for Hedge Accounting**, the **Hedge Accounting** in respect of that **Hedge Relationship** can be used.

Hedging – Hedge Accounting



Hedging – Hedge Accounting

Fair Value Hedge

Hedging Instrument

Hedged Item

⇒ Meets the **Condition for Hedging Accounting**, then:

a) the gain or loss from re-measuring the **Hedging Instrument** at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with HKAS 21 (for a non-derivative hedging instrument)
   - **shall be recognised in profit or loss**

b) the gain or loss on the **Hedged Item** attributable to the hedged risk
   - **shall adjust the carrying amount of the Hedged Item and be recognised in profit or loss.**

   This applies if the hedged item is otherwise measured at cost.
   Recognition of the gain or loss attributable to the hedged risk in P/L applies if the hedged item is an available-for-sale financial asset.

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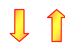
Hedging – Hedge Accounting

Fair Value Hedge

Hedging Instrument



Hedged Item

Hedging instrument's change in fair value recognised in P/L

Income Statement

Hedged item's gain or loss attributable to the hedged risk shall adjust its carrying amount and be recognised in P/L

adjust its carrying amount

Even the Hedged Item is measured at
- Cost (say HTM investment) or
- Fair Value through Equity (AFS financial assets)

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Hedging – Hedge Accounting

Fair Value Hedge

- Any adjustment to the carrying amount of a hedged financial instrument that is measured at amortised cost shall be amortised to profit or loss.
- Amortisation may begin as soon as an adjustment exists and shall begin no later than when the Hedged Item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.
- The adjustment is based on a recalculated effective interest rate at the date amortisation begins.
- Only for a Fair Value Hedge of the interest rate exposure of a portfolio of financial assets (or liabilities), the adjustment shall be amortised using a straight-line method.

Hedged Item

adjust its carrying amount

Even the Hedged Item is measured at
- Cost (say HTM investment) or
- Fair Value through Equity (AFS financial assets)

Hedging – Hedge Accounting

Example

- Entity A has an investment in one Share Y classified as available for sale.
- To partially protect against decreases in the price of Share Y, Entity A
  - acquires a put option on one share of Share Y, and
  - designates the change in the intrinsic value of the put as a hedging instrument in a **Fair Value Hedge** of changes in the fair value of Share Y.
- The put gives Entity A the right to sell one Share Y at a strike price of $90.
- At the inception of the hedging relationship, the share has a quoted price of $100.
- Since the put option gives Entity A the right to dispose of Share Y at $90, the put should normally be fully effective in offsetting price declines below $90 on an intrinsic value basis.
- Price changes above $90 are not hedged.
- In this case, are changes in the fair value of Share Y for prices above $90 regarded as hedge ineffectiveness and recognised in profit or loss under HKAS 39?

Hedging – Hedge Accounting

Example

No.

- HKAS 39 permits Entity A to designate changes in the intrinsic value of the option as the hedging instrument.
  - It provide protection against the risk of variability in the fair value of one Share Y below or equal to the strike price of the put of $90.
  - For prices above $90, the option is out of the money and has no intrinsic value.
  - Accordingly, gains and losses on Share Y for prices above $90 are not attributable to the hedged risk for the purposes of assessing hedge effectiveness and recognising gains and losses on the hedged item.
- Thus, Entity A reports changes in the fair value of Share Y if it is associated with variation in its price above $90 (in Equity if it is AFS financial asset).
- Changes in fair value of Share Y associated with price declines below $90 form part of the designated Fair Value Hedge and are recognised in profit or loss.
- Assuming the hedge is effective, those changes are offset by changes in the intrinsic value of the put, which are also recognised in profit or loss.
- Changes in the time value of the put are excluded from the designated hedging relationship and recognised in profit or loss under HKAS 39.

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Hedging – Hedge Accounting

Example

- Can Entity A designate its inventories, copper inventory, as the Hedged Item in a Fair Value Hedge of the exposure to changes in the price of the inventories, such as the copper price, although inventories are measured at the lower of cost and net realisable value under HKAS 2 *Inventories*?

Yes.

- The inventories may be hedged for changes in fair value due to changes in the copper price.
- Because the change in fair value of inventories will affect profit or loss when the inventories are sold or their carrying amount is written down.
- The adjusted carrying amount becomes the cost basis for the purpose of applying the lower of cost and net realisable value test under HKAS 2.
- The Hedging Instrument used in a Fair Value Hedge of inventories may alternatively qualify as a Cash Flow Hedge of the future sale of the inventory.

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Hedging – Hedge Accounting

Example

- Company A purchases a bond that has a principal amount of $1 million at a fixed interest rate of 6% per year.
- The bond is classed as an available-for-sale financial asset.
- The fair value of the instrument is $1 million.
- The company enters into an interest rate swap. It exchanges the fixed interest rate payments it receives on the bond for floating interest rate payments, in order to offset the risk of a decline in fair value.
- Company designates and documents the swap as a hedging instrument.
- On entering into the swap, the swap has a fair value of zero.
- Assuming market interest rates have increased to 7%, the fair value of the bond will have decreased to $960,000. At the same time, the company determines that the fair value of the swap has increased by $40,000.

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Hedging – Hedge Accounting

Example

- The instrument is classified as available-for-sale, therefore the decrease in fair value would normally be recorded directly in reserves.
- However, since the instrument is a Hedged Item in a Fair Value Hedge, this change in fair value of the instrument is recognised in profit or loss, as follows:

Dr Income statement	$40,000	
Cr Available-for-sale financial asset		$40,000

- While the swap is a derivative, it is measured at fair value with changes in fair value recognised in profit or loss.

Dr Swap receivables	$40,000	
Cr Income statement		$40,000

- The changes in fair value of the Hedged Item and the Hedging Instrument exactly offset each other:
  - the hedge is 100% effective and the net effect on profit or loss is zero.

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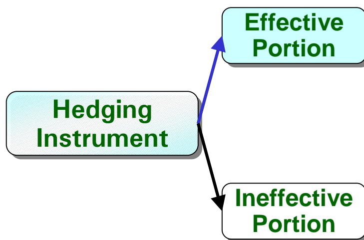
Hedging – Hedge Accounting

Cash Flow Hedge



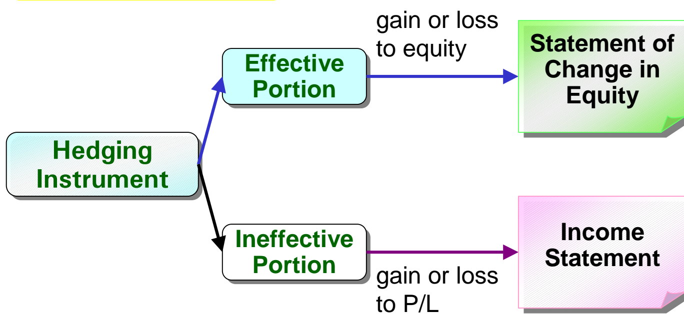
⇒ Meets the **Condition for Hedging Accounting**, then:

a) the portion of the gain or loss on the **Hedging Instrument** that is determined to be **an effective hedge** shall be **recognised directly in equity** through the statement of changes in equity; and

b) the **ineffective portion** of the gain or loss on the **Hedging Instrument** shall be **recognised in profit or loss**.

Hedging – Hedge Accounting

Cash Flow Hedge



How's the treatment, if it is .....

Hedge of a forecast transaction resulting in recognition of **Financial Asset or Financial Liability**

Hedge of forecast transaction resulting in recognition of **Non-Financial Asset or Non-Financial Liability**

Hedging – Hedge Accounting

Cash Flow Hedge

- If a **Hedge of a Forecast Transaction** subsequently results in the recognition of **a financial asset or a financial liability**
  - the associated gains or losses that were recognised directly in equity shall be reclassified into profit or loss in the same period(s) during which the asset acquired or liability assumed affects profit or loss (such as in the periods that interest income or interest expense is recognised)
- If any loss recognised directly in equity is expected not to be recovered in one or more future periods
  - it shall reclassify such loss into profit or loss.

Hedge of a forecast transaction resulting in recognition of **Financial Asset or Financial Liability**

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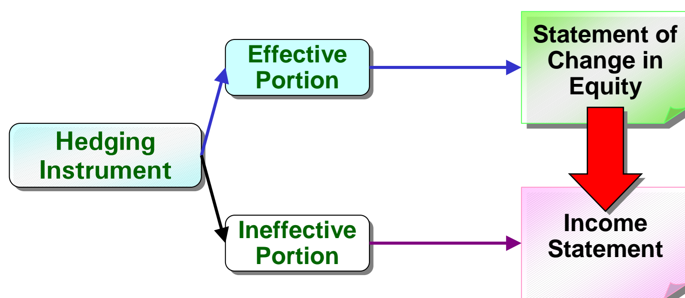
Hedging – Hedge Accounting

Cash Flow Hedge



Reclassified associated gain or loss recognised in equity to P/L in case of
- Final recognition of financial assets or financial liabilities, or
- Loss recognised directly in equity is expected not to be recovered

Hedge of a forecast transaction resulting in recognition of **Financial Asset or Financial Liability**

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Hedging – Hedge Accounting

Cash Flow Hedge

- If a **Hedge of a Forecast Transaction** subsequently results in
  - the recognition of a non-financial asset or a non-financial liability**,** or
  - a forecast transaction for such non-financial item becomes a firm commitment for which fair value hedge accounting is applied
- Then an entity shall adopt (a) or (b) below:

a) Reclassifies the associated gains and losses recognised in equity into P/L in the same period(s) during which the asset acquired or liability assumed affects P/L (such as in the periods that depreciation expense or cost of sales is recognised).
If any loss recognised directly in equity is expected not to be recovered in one or more future periods, it shall reclassify into P/L such loss.

b) Removes the associated gains and losses recognised directly in equity, and includes them in the initial cost or other carrying amount of the asset or liability.

Once adopt either (a) or (b), apply consistently

Hedge of forecast transaction resulting in recognition of **Non-Financial Asset or Non-Financial Liability**

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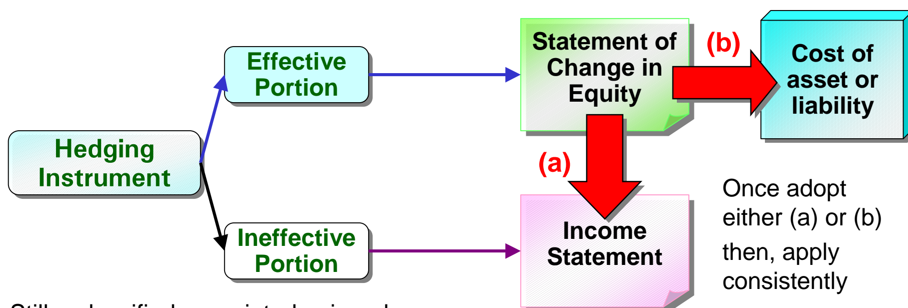
Hedging – Hedge Accounting

Cash Flow Hedge



Still reclassified associated gain or loss recognised in equity to P/L when

- Loss recognised directly in equity is expected not to be recovered

Associated gain or loss will also be either
a) reclassified to P/L, or
b) included in cost of assets or liabilities

Hedge of forecast transaction resulting in recognition of **Non-Financial Asset or Non-Financial Liability**

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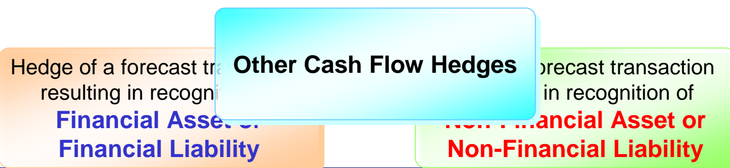
Hedging – Hedge Accounting

Cash Flow Hedge

- For cash flow hedges other than those discussed
  - amounts that had been recognised directly in equity shall be recognised in profit or loss in the same period(s) during which the hedged forecast transaction affects P/L (for example, when a forecast sale occurs).



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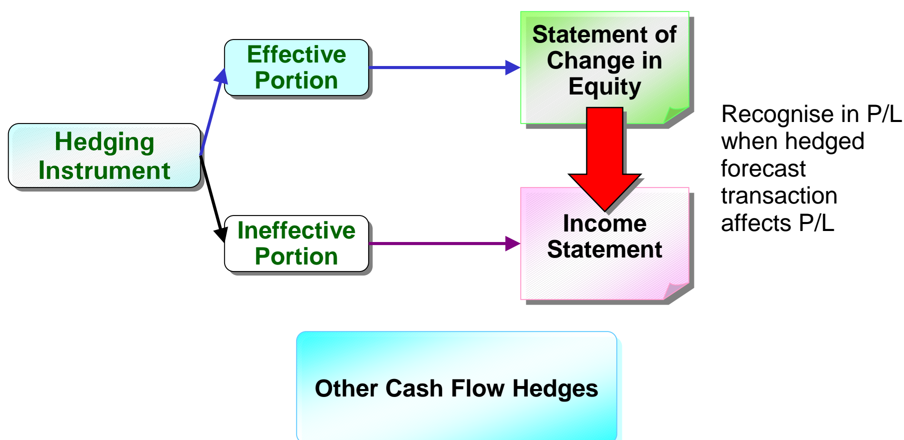
Hedging – Hedge Accounting

Cash Flow Hedge



Other Cash Flow Hedges

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Hedging – Hedge Accounting

Example

- <u>Company 2066</u> has <u>a foreign currency liability</u> payable in 6 months' time.
- It wishes to hedge the amount payable on settlement against foreign currency fluctuations.
- To that end, it <u>takes out a forward contract</u> to buy the foreign currency in 6 months' time.
- Should the hedge be treated as:
  a) Fair Value Hedge of the foreign currency liability with gains and losses on revaluing the liability and the forward contract at the year-end both recognised in the income statement; or
  b) Cash Flow Hedge of the amount to be settled in the future with gains and losses on revaluing the forward contract recognised in equity?

- HKAS 39 does not preclude either of these 2 methods ← discussed
- Hedge Accounting ← discuss now

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Hedging – Hedge Accounting

Example

Hedge Accounting

- If the hedge is treated as a **Fair Value Hedge**
  - the gain or loss on the fair value remeasurement of the hedging and of the hedged item for the hedged risk
    - ➢ are recognised immediately in profit or loss.
- If the hedge is treated as a **Cash Flow Hedge**
  - with the gain or loss on remeasuring the forward contract recognised in equity
  - that amount is recognised in profit or loss in the same period(s) during which the hedged item (the liability) affects profit or loss, i.e. when the liability is remeasured for changes in foreign exchange rates.
  - Thus, if the hedge is effective, the gain or loss on the derivative is released to profit or loss in the same periods during which the liability is remeasured, not when the payment occurs.

Any choice here?

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Hedging – Hedge Accounting

Example

- Entity A exports a product at a price denominated in a foreign currency.
- At the date of the sale, the entity obtains a receivable for the sale price payable in 90 days and takes out a 90-day forward exchange contract in the same currency as the receivable to hedge its foreign currency exposure.
- Under HKAS 21, the sale is recorded at the spot rate at the date of sale, and the receivable is restated during the 90-day period for changes in exchange rates with the difference being taken to profit or loss.
- If the foreign exchange contract is designated as a hedging instrument, does the entity have a choice whether to designate the foreign exchange contract
  - as a **Fair Value Hedge** of the foreign currency exposure of the receivable, or
  - as a **Cash Flow Hedge** of the collection of the receivable?

Hedging – Hedge Accounting

Example

Yes.

- If Entity A designates the foreign exchange contract as a **Fair Value Hedge**
  - the gain or loss from remeasuring the forward exchange contract at fair value is recognised immediately in profit or loss and
  - the gain or loss on remeasuring the receivable is also recognised in profit or loss.
- If Entity A designates the foreign exchange contract as a **Cash Flow Hedge** of the foreign currency risk associated with the collection of the receivable
  - the portion of the gain or loss that is determined to be an effective hedge is recognised directly in equity, and
  - the ineffective portion is recognised in profit or loss.
  - the amount recognised directly in equity is transferred to profit or loss in the same period(s) during which changes in the measurement of the receivable affect profit or loss.

Any choice here?

Hedging – Hedge Accounting

Example

- Entity A designates a non-derivative monetary asset as a foreign currency Cash Flow Hedge of the repayment of the principal of a non-derivative monetary liability.
- Can the exchange differences
  - on the **Hedged Item** be recognised in profit or loss, and
  - on the **Hedging Instrument** be recognised in equity until the repayment of the liability?

No.

- Exchange differences on the monetary asset and the monetary liability are both recognised in profit or loss in the period in which they arise.
- As discussed before, foreign exchange difference even on AFS financial assets cannot be recognised in equity.
- HKAS 39 specifies that even if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in fair values (of the foreign currency component) of those financial instruments are recognised in profit or loss.

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Hedging – Hedge Accounting

Example

- Entity A trades in UK mainly in UK Sterling.
- It expects to purchase a machine for 1 million Euros in one year from 1 May 2006.
- In order to offset the risk of increases in the Euro rate, Entity A enters into a forward contract to purchase 1 million Euros in 1 year for a fixed amount (£650,000).
- The forward contract is designated as a Cash Flow Hedge.
- At inception, the forward contract has a fair value of zero.
- At the year-end of 31 October 2006, the Euro has appreciated and the value of 1 million Euros is £660,000.
- The machine will still cost 1 million Euros so the company concludes that the hedge is 100% effective.

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Hedging – Hedge Accounting

Example

- The entire change in the fair value of the hedging instrument is recognised directly in reserves.
  Dr Forward contract £10,000
  Cr Reserves £10,000 ← How to treat this amount finally?
- The forward contract is settled with no further change in the exchange rate:
  Dr Cash £10,000
  Cr Forward contract £10,000
- The company purchases the machine for 1 million euros and makes the following journal entry:
  Dr Machine £660,000
  Cr Accounts Payable £660,000
- The gain of £10,000 recognised in reserve (equity) should either
  - be reclassified from equity into P/L, or
  - be reclassified from equity and included in the initial carrying amount of the machine (for non-financial assets or liabilities only)
  - once this policy is chosen, it must be used consistently

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Hedging – Hedge Accounting

Example

- Entity A has a floating rate liability of $1,000 with 5 years remaining to maturity.
- It enters into a 5-year pay-fixed, receive-floating interest rate swap in the same currency and with the same principal terms as the liability to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk.
- At inception, the fair value of the swap is zero.
- Subsequently, there is an increase of $49 in the fair value of the swap.
  - Consists of a change of $50 resulting from an increase in market interest rates, and
  - a change of minus $1 resulting from an increase in the credit risk of the swap counterparty.
- There is no change in the fair value of the floating rate liability, but the fair value (present value) of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by $50.
- Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognised in profit or loss?

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Hedging – Hedge Accounting

Example

No.

- A hedge of interest rate risk is not fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.
- However, because Entity A determines that the hedge relationship is still highly effective, it credits the effective portion of the change in fair value of the swap, i.e. the net change in fair value of $49, to equity.
- There is no debit to profit or loss for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty, because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, i.e. $50, exceeds the cumulative change in value of the hedging instrument, i.e. $49.

		Dr	Cr
Dr	Swap	$49	
Cr	Equity		$49

- If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceased to be highly effective in accordance with HKAS 39.

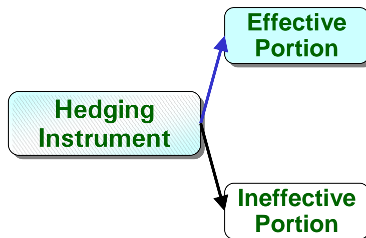
Hedging – Hedge Accounting

Case

In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:

- The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognized in hedging reserve.
- The gain or loss relating to the ineffective portion is recognized immediately in the consolidated profit and loss account.
- Amounts accumulated in hedging reserve are recycled in the consolidated profit and loss account in the periods when the hedged item will affect profit or loss (for instance when the forecast sale that is hedged takes place).
- However, when the forecast transaction that is hedged results in the recognition of a non-financial asset (for example, inventory) or a liability, the gains and losses previously deferred in hedging reserve are transferred from hedging reserve and included in the initial measurement of the cost of the asset or liability.

Hedging – Hedge Accounting



Including a hedge of a monetary item that is accounted for as part of the net investment, shall be accounted for similarly to **Cash Flow Hedges**:

a) the portion of the gain or loss on the **Hedging Instrument** that is determined to be an **effective hedge** shall be **recognised directly in equity** through the statement of changes in equity; and

b) the **ineffective portion** shall be **recognised in profit or loss**.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised directly in equity shall be recognised in profit or loss on disposal of the foreign operation.

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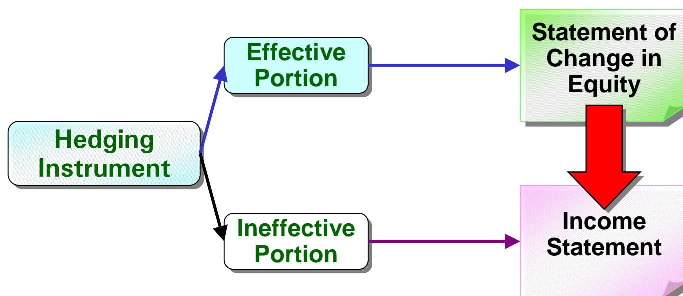
Hedging – Hedge Accounting



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Hedge – Cease Hedge Accounting

An entity shall discontinue prospectively the **Hedge Accounting** if:

a) the hedging instrument expires or is sold, terminated or exercised;
b) the hedge no longer meets the **Conditions for Hedge Accounting**;
c) the entity revokes the designation; or
d) in case of a **Cash Flow Hedge**, the forecast transaction that is hedged is no longer expected to occur.

When the **Hedge Accounting** is discontinued (for **Cash Flow Hedge**), the cumulative gain or loss on the **Hedging Instrument** that remains recognised directly in equity shall:

a) remain separately recognised in equity until the forecast transaction occurs; or
b) be recognised in profit or loss if the forecast transaction is no longer expected to occur.

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Hedge – Cease Hedge Accounting

Case

- In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:
  - When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in hedging reserve at that time remains in hedging reserve and is recognized when the forecast transaction is ultimately recognized in the consolidated profit and loss account.
  - When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in hedging reserve is immediately transferred to the consolidated profit and loss account.
  - Certain derivative instruments do not qualify for hedge accounting. Changes in the fair value of any derivative instruments that do not qualify for hedge accounting are recognized immediately in the consolidated profit and loss account.

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Hedging – Case

Case

ESPRIT

Esprit Holdings Limited

- Accounting policy on derivative financial instruments
  - When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when the forecast transaction is ultimately recognised in the income statement.
  - When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

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Disclosure and Presentation

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Disclosure and Presentation

Presentation from the perspective of the issuer on

- **Liability and equity**
- **Compound financial instruments**
- **Treasury shares**
- **Interests, dividends, losses and gains**

- The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as
  - a financial liability,
  - a financial asset or
  - an equity instrument

  in accordance with
  - the substance of the contractual arrangement and
  - the definitions of a financial liability, a financial asset and an equity instrument. *(assess the substance)*

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Disclosure and Presentation

Presentation from the perspective of the issuer on

- **Liability and equity**

- An instrument can be **an equity instrument** if, and only if, both conditions (a) and (b) below are met.
  a) The instrument includes no contractual obligation:
     i) to deliver cash or another financial asset; or
     ii) to exchange financial instrument under conditions that are potentially unfavourable to the issuer.
  b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
     i) a non-derivative that includes no contractual obligation to deliver a variable no. of its own equity instruments; or
     ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

Contractual obligation, including one arising from a derivative, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

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Disclosure and Presentation

Presentation from the perspective of the issuer on

Liability and equity

Compound financial instruments

- A compound financial instrument is an instrument containing both a liability and an equity component
- An entity shall evaluate whether a financial instrument contains both a liability and an equity component
- Such components shall be classified separately as financial liabilities, financial assets or equity instrument in accordance with their definitions
- An entity recognises separately the components of a financial instrument that
  a) creates a financial liability of the entity, and
  b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity.
- In separation of a compound financial instrument, the equity component is assigned the residual amount, after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component

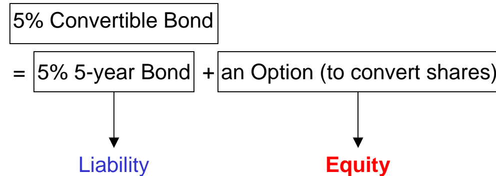
Disclosure and Presentation

Presentation from the perspective of the issuer on

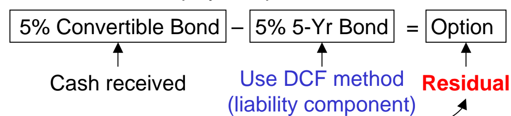
Liability and equity

Compound financial instruments

- For example, an entity issues a 5% 5-year convertible bond
- In fact, it can be analysed as



- To find out the equity component:



- **To classify as Equity**

Disclosure and Presentation – Case

Case

Beijing Enterprises Holdings Limited

- Has early adopted all new HKFRS in 2004 Annual Report, which states:
  - In accordance with the provisions of HKAS 32, the terms of a non-derivative financial instrument are evaluated to determine whether it
    - contains both a liability and an equity component and
    - shall be classified separately as a financial liability or an equity instrument, respectively.

Disclosure and Presentation – Case

Case

Explanation on how to derive

Shanghai Real Estate Limited

- 2004 Annual Report assessed the impact of new HKFRS and stated:
  - According to HKAS 32 and 39, convertible bond
    - is a kind of financial instruments and
    - is divided into liability component and equity conversion component at the issuance of the bond.
  - The fair value of the liability component of a convertible bond is determined using a market interest rate for an equivalent non-convertible bond. This amount is recorded as a liability on an amortised cost basis until extinguished on conversion or maturity of the bond.
  - The residual amount, representing the value of the equity conversion component, is included in shareholders' equity in other reserves, net of deferred income taxes.
  - HKAS 32 should be applied retrospectively and HKSA 39 should be applied prospectively for convertible bonds.

Disclosure and Presentation

Presentation from the perspective of the issuer on

- Liability and equity
- Compound financial instruments
- **Treasury shares**

- Treasury shares (an entity's own equity instruments reacquired by itself or its subsidiaries)
  - Those instruments shall be deducted from equity
  - Cannot be classified as an asset
  - No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments.
  - Such treasury shares may be acquired and held by the entity or by other members of the consolidated group.
  - Consideration paid or received shall be recognised directly in equity.

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Disclosure and Presentation

Presentation from the perspective of the issuer on

- Liability and equity
- Compound financial instruments
- Treasury shares
- **Interests, dividends, losses and gains**

- Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.
- Distributions to holders of an equity instrument shall be debited by the entity directly to equity, net of any related income tax benefit.
- Transaction costs of an equity transaction, other than costs of issuing an equity instrument that are directly attributable to the acquisition of a business, shall be accounted for as a deduction from equity, net of any related income tax benefit.

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Disclosure and Presentation

Presentation from the perspective of the issuer on

- **Liability and equity**
- **Compound financial instruments**
- **Treasury shares**
- **Interests, dividends, losses and gains**

Offsetting

Financial assets and financial liabilities are offset when and only when

1) there is a legally enforceable right to set off, and
2) the entity intends to settle on a net basis

Example - Can discounted bills meet?

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Disclosure and Presentation

HKAS 32 also requires extensive disclosures

- **Liability and equity**
- **Compound financial instruments**
- **Treasury shares**
- **Interests, dividends, losses and gains**

Disclosure

- Risk management policies and hedging activities
- Terms, condition and accounting policies
- Interest rate risk
- Credit risk
- Fair value (for the instrument not carried at fair value)
- Other disclosures (including derecognition, collateral, effect on income statement and equity, reclassification, impairment, and etc)

Offsetting

Financial assets and financial liabilities are offset when and only when

1) there is a legally enforceable right to set off, and
2) the entity intends to settle on a net basis

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Disclosure and Presentation

Case

ESPRIT

Esprit Holdings Limited

- 2004 Annual Report – Notes on Financial Risk Management
  - The Group's activities expose it to foreign exchange risk and credit risk.
  - The Group's overall risk management programme focuses on minimizing potential adverse effects of these risks on the Group's financial performance.
  - The Group uses derivative financial instruments to hedge certain risk exposures.

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Disclosure and Presentation

Case

ESPRIT

Esprit Holdings Limited

- 2004 Annual Report – Notes on Financial Risk Management

a) Foreign exchange risk
The Group operates internationally and is exposed to foreign exchange risk arising from various currency exposures, primarily with respect to the Euro. Foreign exchange risk arises from future commercial transactions, recognised assets and liabilities and net investments in foreign operations.
To manage the foreign exchange risk arising from future commercial transactions and recognised assets and liabilities, the Group enters into foreign exchange forward contracts, to reduce foreign exchange risk.

b) Credit risk
The Group has no significant concentrations of credit risk. It has policies in place to ensure that wholesale sales of products are made to customers with an appropriate credit history. Sales to retail customers are made in cash or via major credit cards.

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Transitional Arrangements

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Transitional Arrangements

- Early application is permitted (revised in Nov. 2004)
- At the beginning of the year in which HKAS 39 is initially applied:
  - Derecognition
    - If a securitisation, transfer, or other derecognition transaction was entered into prior to the beginning of the year in which HKAS 39 is initially applied, the accounting for that transaction shall not be retrospectively changed to conform to the requirements of HKAS 39;

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Transitional Arrangements

- Early application is permitted (revised in Nov. 2004)
- At the beginning of the year in which HKAS 39 is initially applied:
  - Derivative
    - Recognise all derivatives in its balance sheet as either assets or liabilities and should measure them at fair value (subject to exemption)
  - Hedging
    - If the previously designated hedge does not meet the conditions for an effective hedge under HKAS 39 and the hedging instrument is still held, hedge accounting will no longer be appropriate starting with the adoption of HKAS 39.
    - Accounting in prior years should not be retrospectively changed to conform to the requirements of HKAS 39
    - Transactions entered into before the beginning of the financial year in which HKAS 39 is initially applied should not be retrospectively designated as hedges

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Transitional Arrangements

- Early application is permitted (revised in Nov. 2004)
- At the beginning of the year in which HKAS 39 is initially applied:
  - Fair value hedge
    - Any balance sheet positions in Fair Value Hedges of existing assets and liabilities should be accounted for by adjusting their carrying amounts to reflect the fair value of the hedging instrument
  - Cash flow hedge
    - Any deferred gains and losses on Cash Flow Hedge should be reclassified as a separate component of equity to the extent that the transactions meet the criteria in HKAS 39

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Transitional Arrangements

Case

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

Financial Instrument Standards – Part 2

(HKAS 32 and 39) 11 February 2006

Updated slides may be found in
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Financial Instrument Standards – Part 2

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