

HKAS 32 & 39 and HKFRS 7 – Part II

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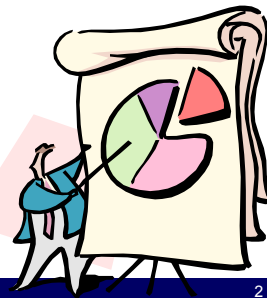
Topics to be discussed

- 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)
- Disclosures amended by HKFRS 7

Simple but
Comprehensive

Key Issues

Cases and Examples



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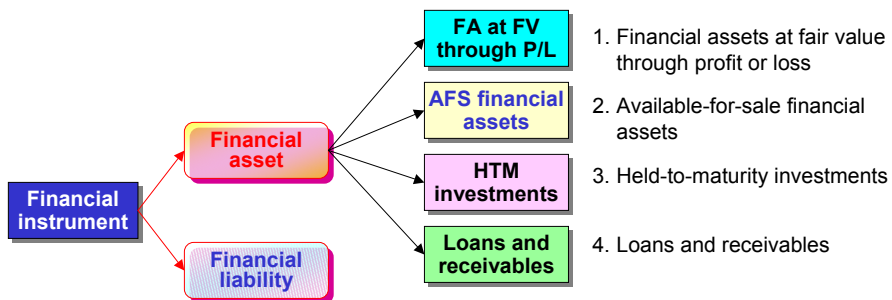
Recap on Recognition & Measurement



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Recap on Recognition & Measurement



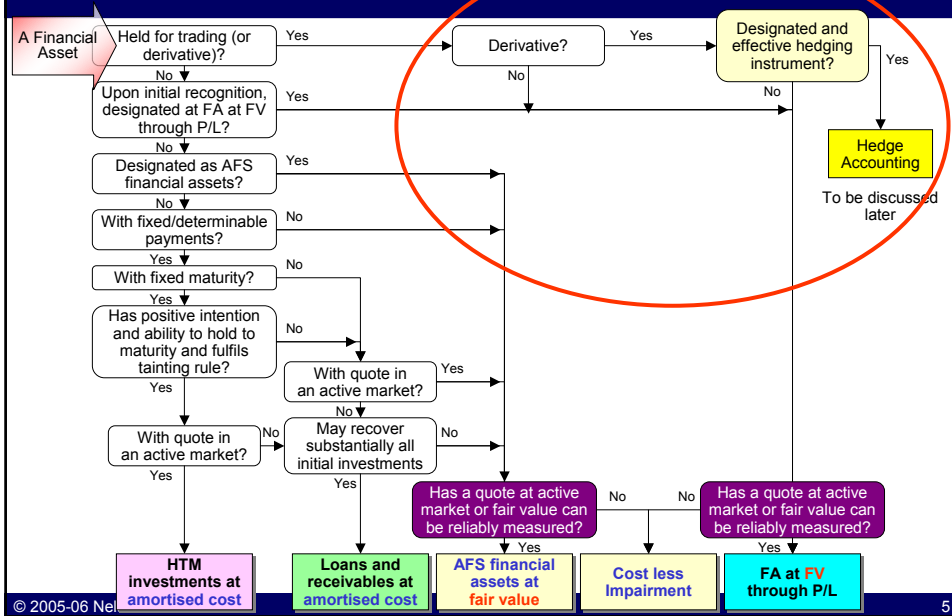
- Initial recognition and measurement principle for financial assets and financial liabilities are the same
- But, HKAS 39 further defines financial asset into 4 categories for subsequent measurement (financial liability to be discussed later)

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

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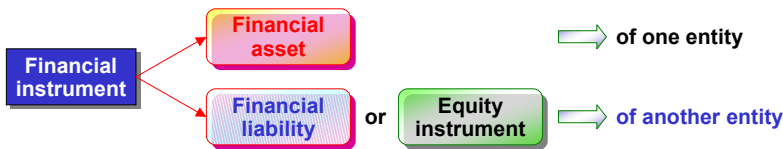
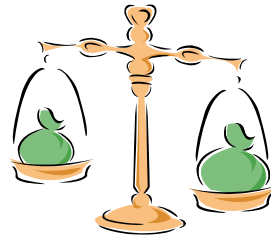
Recap on Recognition & Measurement



Recap on Recognition & Measurement

	<u>Subsequent Measurement</u>	<u>Impairment</u>	<u>Reversal</u>	<u>Reclassification</u>
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

Definitions – Derivative



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Definitions – Derivative

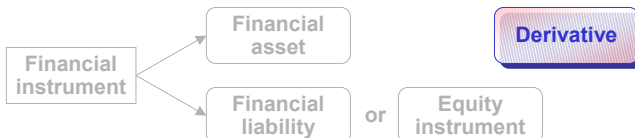
Derivative ⇒ is a financial instrument or other contract within the scope of HKAS 39 with all 3 of the following characteristics:

Value change based on an underlying

Little or no initial net investment

Settled at a future date

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying');
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.



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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

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?

Value change based on an underlying ✓

Little or no initial net investment ✓

Settled at a future date ✓

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 ✓

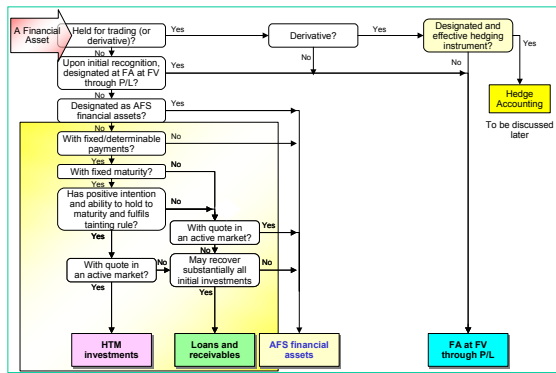
Margin deposit (or account)

- 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.

Embedded Derivatives

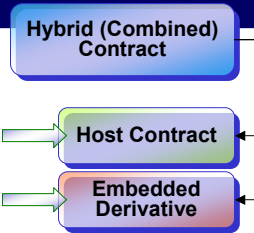


Will derivative elements in the financial assets affect the classification?

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.

Embedded Derivatives

Example

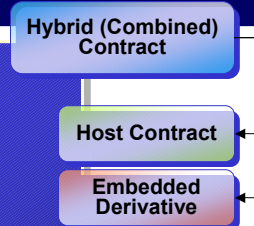
- Investments in convertible bonds (with equity conversion feature)
- Equity-indexed interest or principal payments embedded in a host debt instrument (equity-linked interest or principal payments)
- An option or automatic provision to extend the remaining term to maturity of a debt instrument
- A call, 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?**



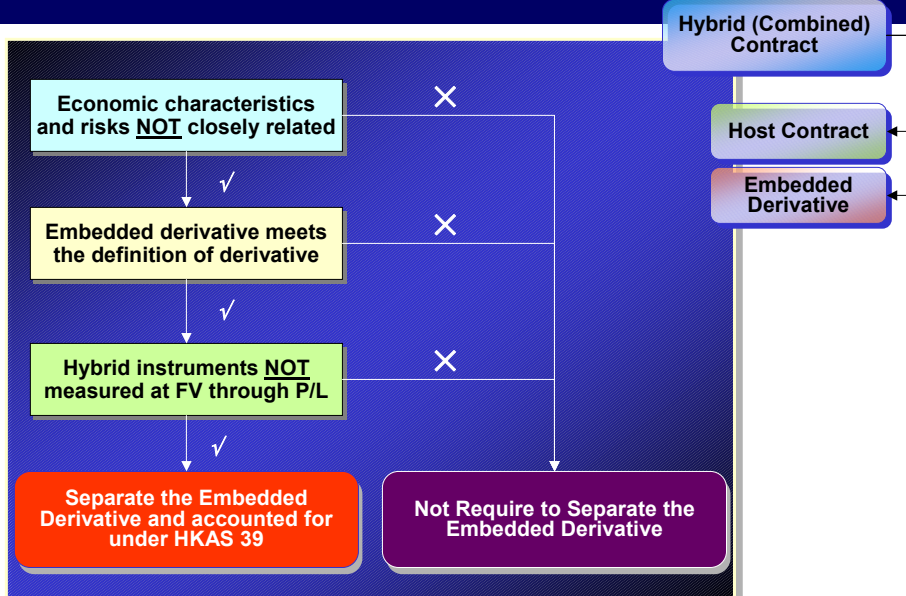
Embedded Derivatives

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



Embedded Derivatives



Embedded Derivatives

Economic characteristics and risks **NOT** closely related

To assess economic characteristics and risks

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

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 **cannot** be measured

- ⇒ Entire Hybrid (Combined) Contract is classified as financial instrument that is held for trading

If separation is not required

- ⇒ Hybrid (combined) contract shall be accounted for under applicable HKFRS

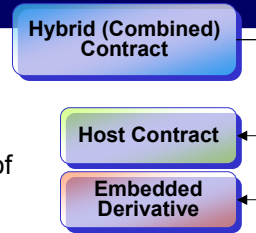
Separate the Embedded Derivative and accounted for under HKAS 39

Not Require to Separate the Embedded Derivative

Embedded Derivatives

To separate embedded derivative

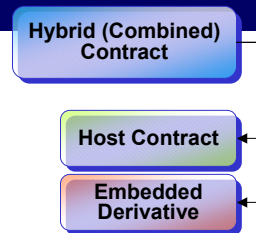
- An embedded non-option derivative (such as an embedded forward or swap)
 - is separated from its host contract on the basis of its stated or implied substantive terms,
 - so as to result in it having a fair value of zero at initial recognition.
- An embedded option-based derivative (such as an embedded 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.



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.



- 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.

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.

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?

Embedded Derivatives

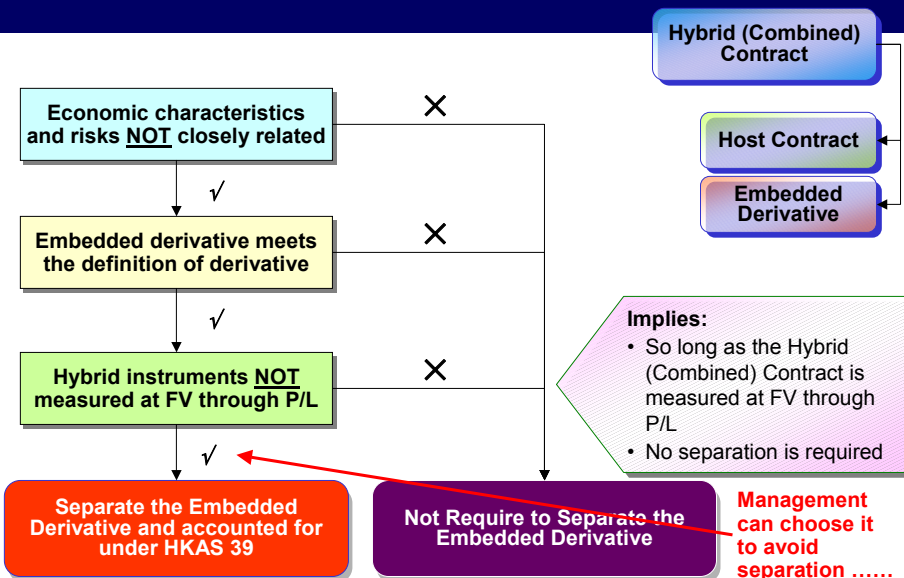
Example

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.

Embedded Derivatives



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.

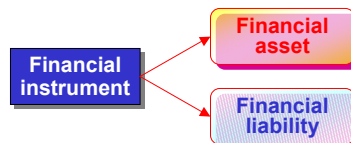
Available-for-sale financial assets

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."

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

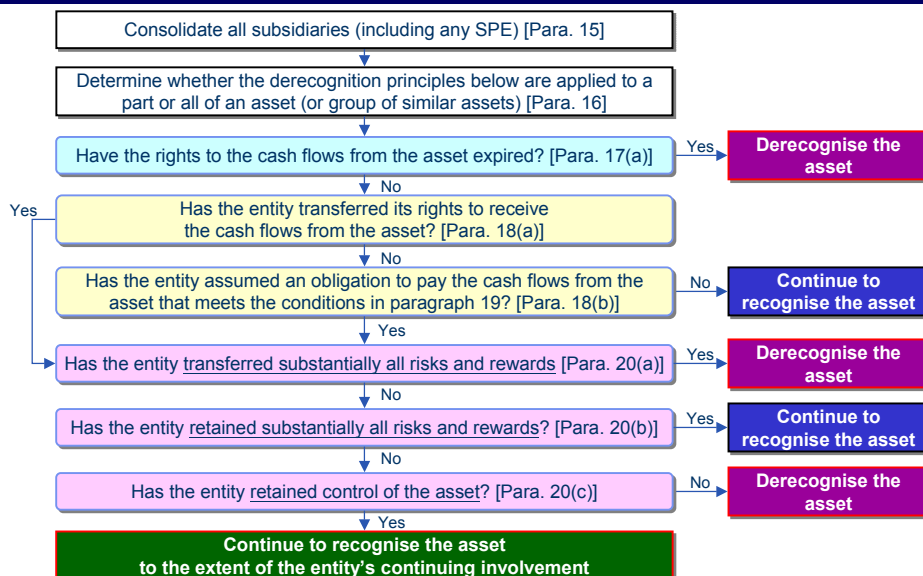
Further Test 1:
Asset Transfer Test

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

Derecognition of Financial Assets



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

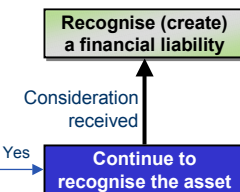
Has the entity transferred substantially all risks and rewards [Para. 20(a)]

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

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)]

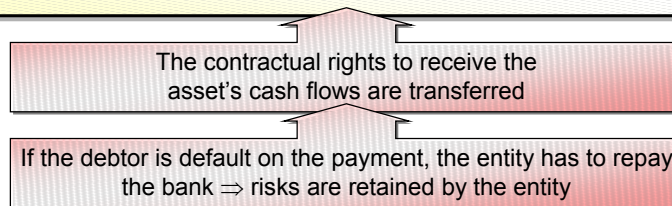


Derecognition of Financial Assets

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

Case

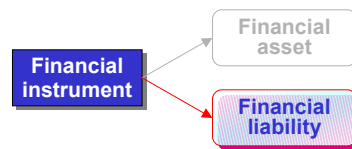


- In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:
 - the Group's discounted bills with recourse,
 - which were previously treated as contingent liabilities,
 - have been accounted for as collateralized bank advances prospectively on or after 1 January 2005,
 - as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

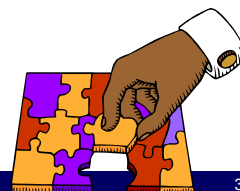
Total advances recognised:	HK\$ 822M
Current liabilities of that date:	7,578M
Net current assets of that date:	1,229M

Derecognition of Financial Liability

- 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 assumedshall be recognised in profit or loss.



Hedging and Hedge Accounting



Hedging – Introduction

A Hedge under HKAS 39 involves 2 components

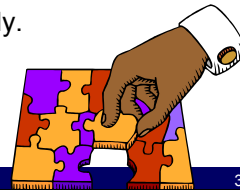


- Strict conditions must be fulfilled before **Hedge Accounting** can be used.
- But even qualified, an entity can also choose not to use it, but

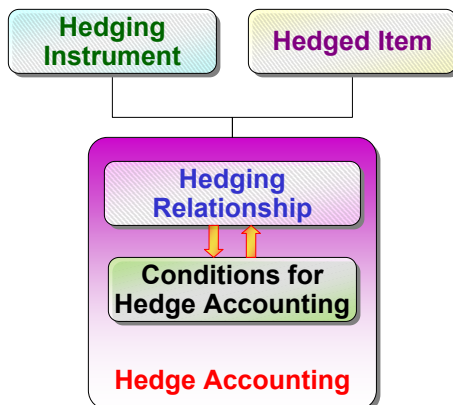
HKAS 39 sets out **Hedge Accounting** which recognises the offsetting effects on profit or loss of changes in the fair values of these 2 components.

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

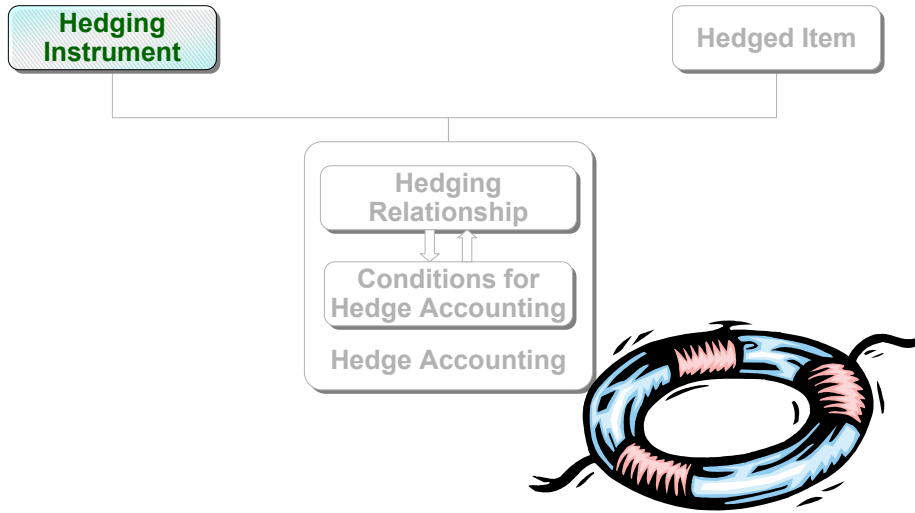


HKAS 39

- defines and restricts the items qualified as
 - **Hedging Instruments** and
 - **Hedged Items**
- Sets out the types of **Hedge Relationship**
- Requires **Conditions for Hedge 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**.

Hedging – Hedging Instruments



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.

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?

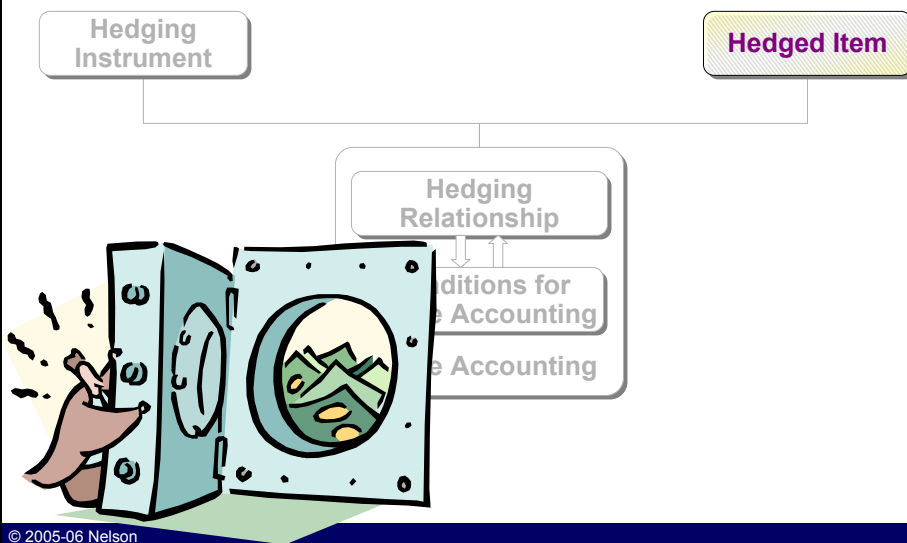
1. No.

- 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.

Hedging – Hedged Item



Hedging – 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.

Hedged Item

- 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.

Hedging – Hedged Item

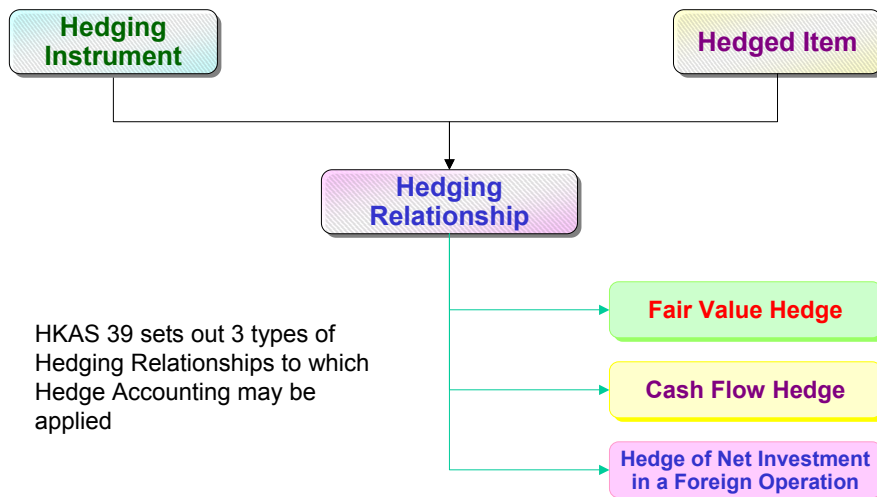
Example

- 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.

Hedging – Hedged Relationship



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Hedging – Hedged Relationship

Fair Value Hedge

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

A hedge of the exposure to variability in cash flows that

- is attributable to a particular risk associated with a recognised asset or liability, or a highly probable forecast transaction and
- 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

Fair Value Hedge

Cash Flow Hedge

Hedge of Net Investment
in a Foreign Operation

Determine the classification for the following hedge:

- Entity A has a floating rate bond and enters into an interest rate swap by receiving fixed and paying float
- Entity B has a fixed rate bond and enters into an interest rate swap by receiving float and paying fixed
- Entity C issues a floating rate bond and enters into an interest rate swap by paying fixed and receiving float
- Entity D issues a floating rate bond and buys an interest rate cap

Hedging

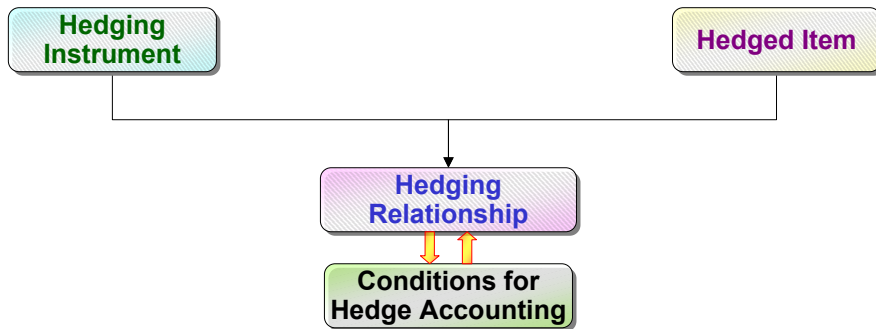
Case

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**).

Hedging – Hedge Accounting Conditions



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

Hedging – Hedge Accounting Conditions

All 5 Conditions for Hedge Accounting must be met:

Formal documentation at inception

Highly effective and consistent with originally documented risk

Forecasted transaction to be highly probable (for cash flow hedge)

Hedge effectiveness can be reliably measured

Ongoing-assessed and actually highly effective

Conditions for Hedge Accounting

Hedging – Hedge Accounting Conditions

Formal documentation
at inception

- 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.
- That documentation shall include:
 - identification of the hedging instrument,
 - the hedged item or transaction,
 - the nature of the risk being hedged and
 - how the entity will assess
 - the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

Hedge
Effectiveness

Hedging – Hedge Accounting Conditions

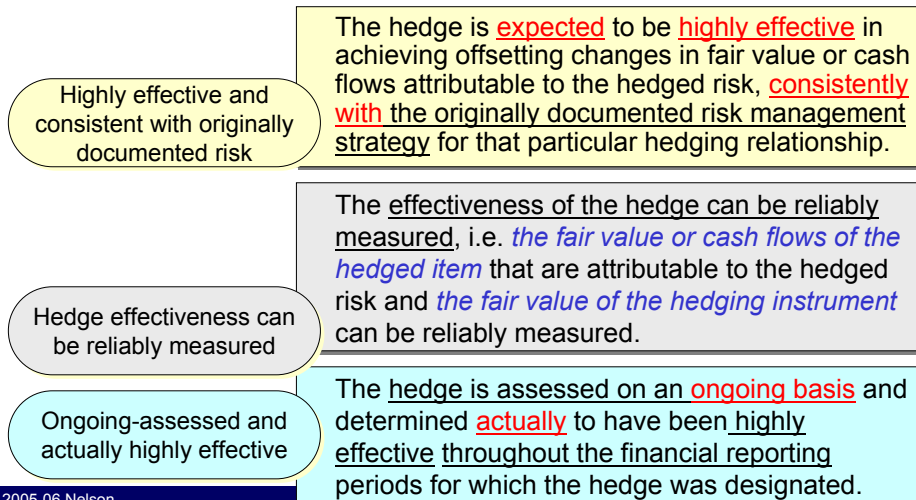
Forecasted transaction
to be highly probable
(for cash flow hedge)

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.

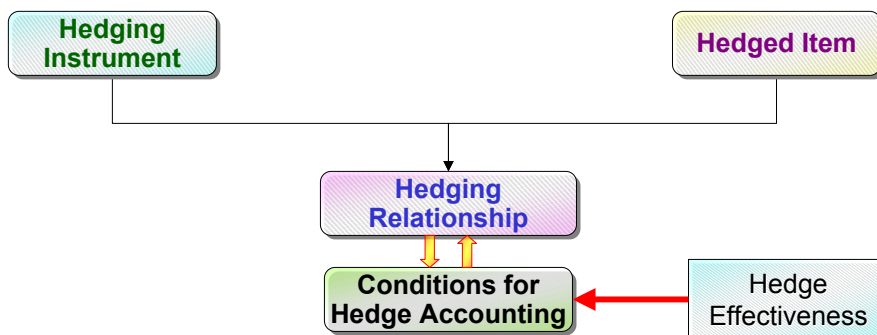
Hedging – Hedge Accounting Conditions

Measurable and highly effective hedge from the beginning to the end



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Hedging – Assess Hedge Effectiveness



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Hedging – Assess Hedge Effectiveness

- **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.

Hedge
Effectiveness

Hedging – Assess Hedge Effectiveness

A hedge is regarded as **highly effective** only if both of the following conditions are met:

- Inception and Ongoing**
Prospective testing
- 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.
- Actual results**
Retrospective testing
- 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 financial statements or
 - interim financial statements.

Hedging – Assess Hedge Effectiveness

Example

Hedging Instrument

→ Gain is \$125

- The degree of offset can be measured by either
 - $\$125 \div \100 , which is 125%, or
 - $\$100 \div \125 , which is 80%

Hedged Item

→ Loss is \$100

within 80% to 125% range

Actual results

- b) The actual results of the hedge are within a range of 80% – 125%.

Retrospective testing

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Hedging – Assess Hedge Effectiveness

Example

What should be placed attention on option type hedging instruments, say cap?

Actual results

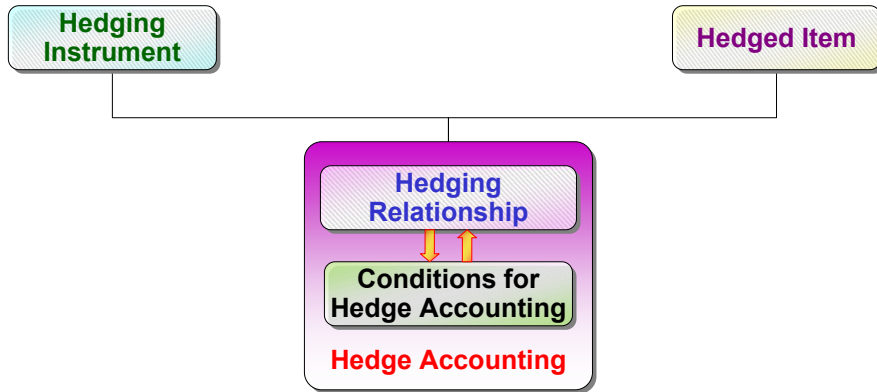
Retrospective testing

- How do we assess the actual hedge effectiveness (cash flow hedge) on
 - interest rate swap or
 - interest rate cap (or caplets)?

- Value changes of option-type hedging instruments consist of:
 - time value changes and
 - intrinsic value changes
- Normally, time value changes would be excluded from the hedge relationship (as established in hedge documentation).
- If it is not excluded, the hedge may not be highly effective. As a result, the hedge accounting may not be applied.

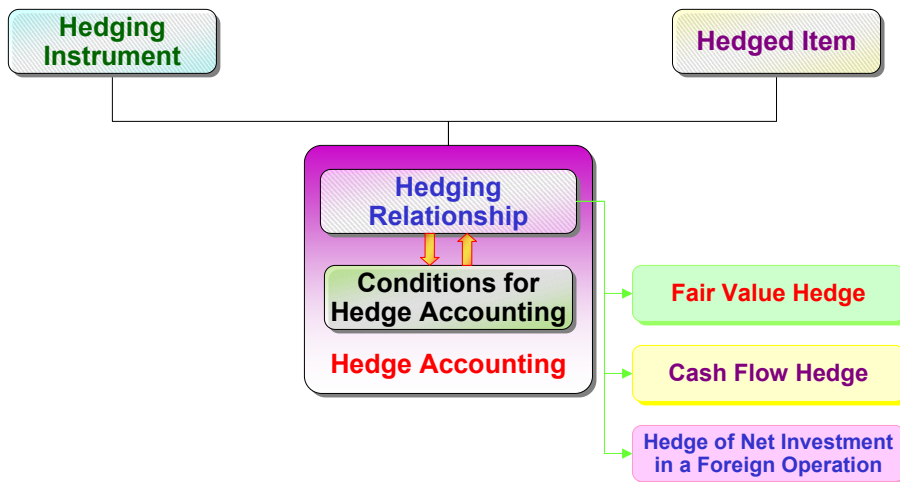
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Hedging – Hedge Accounting



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.

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)

Hedging – Hedge Accounting

Fair Value Hedge

Hedged Item

adjust its
carrying amount

- 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.

Even the Hedged Item is measured at

- Cost (say HTM investment) or
- Fair Value through Equity (AFS financial assets)

Hedging – Hedge Accounting

Example

Hedge of Inventory

- Can Entity A designate its inventories, say copper, as the hedged item in a Fair Value Hedge of the exposure to changes in the copper price?
 - However, 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.

Hedging – Hedge Accounting

Example

Interest Rate Swap on A Fixed Rate Financial Asset

- Company A purchases a bond that
 - has a principal amount of \$1 million at a fixed interest rate of 6% per year.
 - is classified as an available-for-sale financial asset.
 - has a fair value of \$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.
 - It designates and documents the swap as a hedging instrument.
 - The swap has a fair value of zero at the inception of hedge.
- Assuming
 - The market interest rates have increased to 7% and the fair value of the bond will have decreased to \$960,000.
 - The fair value of the swap has increased by \$40,000.

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:

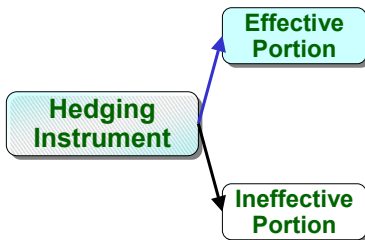
Dr Income statement	\$40,000
Cr Available-for-sale financial asset	\$40,000
- While the swap is a derivative, it is measured at fair value with changes in fair value recognised in profit or loss.

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.

Hedging – Hedge Accounting

Cash Flow Hedge

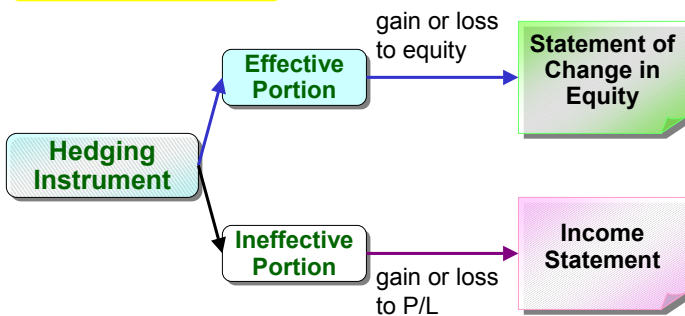
⇒ Meets the **Condition for Hedging Accounting**, then:



- 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

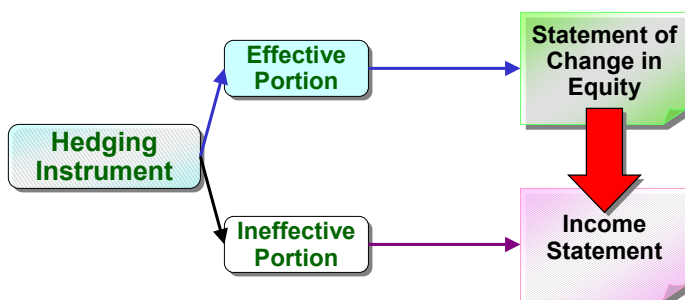
Cash Flow Hedge

- 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**

Hedging – Hedge Accounting

Cash Flow Hedge



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

- 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

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.

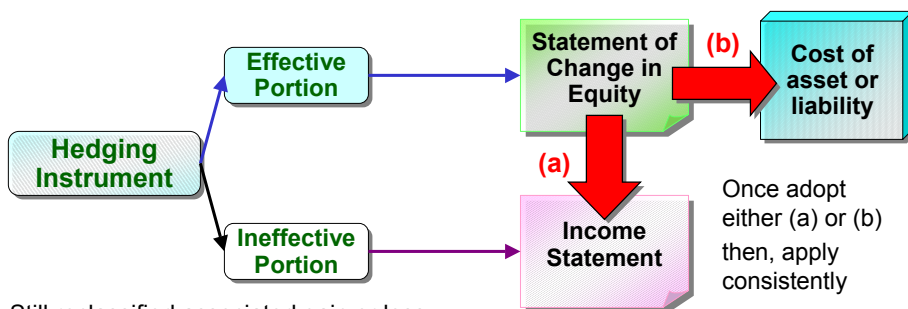
b) Removes the associated gains and losses recognised directly in equity, and includes them in the initial cost or other carrying amount of the asset or liability.

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

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

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

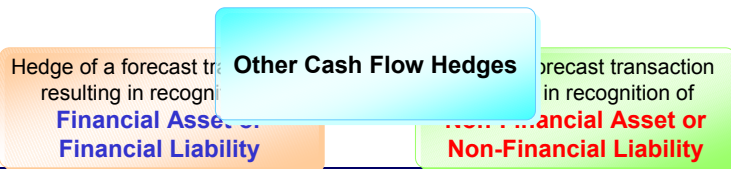
a) reclassified to P/L, or
b) included in cost of assets or liabilities

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

Hedging – Hedge Accounting

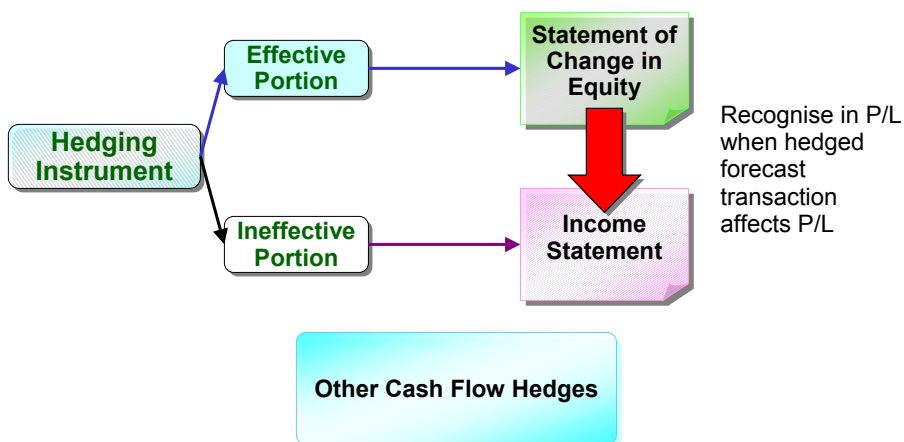
Cash Flow Hedge

- 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).



Hedging – Hedge Accounting

Cash Flow Hedge



Hedging – Hedge Accounting

Example

Hedge of Forecast Transaction

- 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 fair value of the forward contract rises to £10,000.
 - The machine will still cost 1 million Euros so the company concludes that the hedge is 100% effective.

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

Hedging – Hedge Accounting

Case

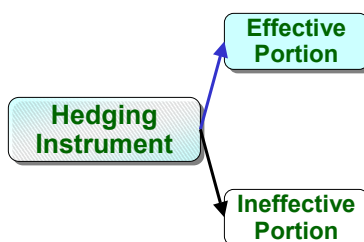


In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:

- 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

Hedge of Net Investment in a Foreign Operation



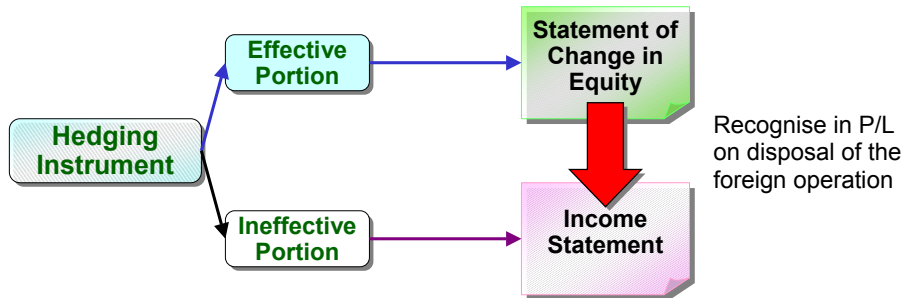
Including a hedge of a monetary item that is accounted for as part of the net investment, shall be accounted for similarly to **Cash Flow Hedges**:

- 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.

Hedging – Hedge Accounting

Hedge of Net Investment in a Foreign Operation



Hedge – Cease Hedge Accounting

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

- the hedging instrument expires or is sold, terminated or exercised;
- the hedge no longer meets the **Conditions for Hedge Accounting**;
- the entity revokes the designation; or
- 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:

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

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.

Disclosure and Presentation



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 instrumentin 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*)

Disclosure and Presentation

Presentation from the perspective of the issuer on

Liability and equity

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.

- 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.

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

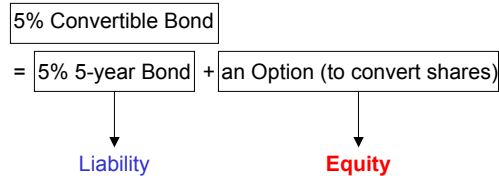
Disclosure and Presentation

Presentation from the perspective of the issuer on

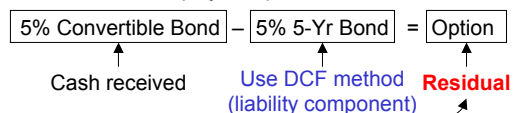
Liability and equity

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



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.

Explanation on how to derive

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.

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.

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 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

Example - Can discounted bills meet?

HKAS 32 – Disclosure

- The purpose of the disclosures required by HKAS 32 is to provide information to
 - enhance understanding of the significance of financial instruments to an entity's financial position, performance and cash flows, and
 - assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments.
- Transactions in financial instruments may result in an entity assuming or transferring to another party one or more of the financial risks.
- The required disclosures provide information to assist users of financial statements in assessing the extent of risk related to financial instruments.



HKAS 32 lists 4 categories of risks

HKAS 32 – Disclosure

4 Categories of risks

Market Risk

Currency Risk

FV Interest Rate Risk

Price Risk

Credit Risk

Liquidity Risk

Cash Flow Interest Rate Risk

- Include 3 types of risks
 - **Currency risk**: the risk that the value of a financial instrument will fluctuate because of changes in foreign exchange rates.
 - **Fair value interest rate risk**: the risk that the value of a financial instrument will fluctuate because of changes in market interest rates.
 - **Price risk**: the risk that the value of a financial instrument will fluctuate as a result of changes in market prices.
- the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.
- the risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments.
- the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

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.

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.

Disclosure Amended by HKFRS 7



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Disclosure Amended by HKFRS 7

- The objective of HKFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- 1) the significance of financial instruments for the entity's
 - financial position and
 - financial performance; and

Significance

- Balance sheet
- Income statement
- Other disclosures

- 2) the nature and extent of risks arising from financial instruments to which the entity is exposed
 - during the period and
 - at the reporting date, andhow the entity manages those risks.

Nature and Extent

- Qualitative disclosures
- Quantitative disclosures

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Disclosure Amended by HKFRS 7

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

Significance

Nature and Extent

1. Significance of Financial Instruments

Significance

- An entity shall disclose information that enables users of its financial statements to evaluate
 - the significance of financial instruments for its financial position and performance.



1. Significance of Financial Instruments

Significance

Balance Sheet

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

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

New in HKFRS 7

New in HKFRS 7

HKAS 32 only requires such disclosures

1. Significance of Financial Instruments

Significance

Balance Sheet

Additional information is required to disclose on:

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

Allowance account for credit losses (say bad debt)

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



No reconciliation required in HKAS 32.94(i)

1. Significance of Financial Instruments

Significance

Income Statement

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

a) net gains or net losses on:

- i) financial assets or financial liabilities at fair value through P/L, showing separately
 - those on financial assets or financial liabilities designated as such upon initial recognition, and
 - those on financial assets or financial liabilities that are classified as held for trading in accordance with HKAS 39;

New in
HKFRS 7

- ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised directly in equity during the period and the amount removed from equity and recognised in profit or loss for the period;

HKAS 32
requires
this only

iii) held-to-maturity investments;

iv) loans and receivables; and

v) financial liabilities measured at amortized cost

New in
HKFRS 7

1. Significance of Financial Instruments

Significance

Income Statement

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

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

New in
HKFRS 7

1. Significance of Financial Instruments

Significance

Other Disclosures

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

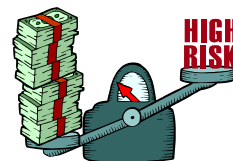
New in
HKFRS 7

2. Nature and Extent of Risks

Nature and Extent

- An entity shall disclose information that enables users of its financial statements to evaluate
 - the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.
- The disclosures required focus on the risks that arise from financial instruments and how they have been managed.
- These risks typically include, but are not limited to
 - credit risk,
 - liquidity risk and
 - market risk.

Currency risk, interest rate risk and other price risk



2. Nature and Extent of Risks

Nature and Extent

Qualitative Disclosures

- For each type of risk arising from financial instruments, an entity shall disclose:
 - a) The exposures to risk and how they arise;
 - b) Its objectives, policies and processes for managing the risk and the methods used to measure the risk
 - c) Any changes in (a) or (b) from the previous period.



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2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

- For each type of risk arising from financial instruments, an entity shall disclose:
 - Summary quantitative data about its exposure to that risk at the reporting date.
- The level of detail of such disclosure is based on:
 - The information provided internally to key management personnel of the entity (as defined in HKAS 24 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.
- If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.



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2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Credit risk

- An entity shall disclose by class of financial instrument:
 - a) the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (e.g. netting agreements that do not qualify for offset in accordance with HKAS 32);
 - b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancements;
 - c) information about the credit quality of financial assets that are neither past due nor impaired; and
 - d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Credit risk

- For financial assets that are either past due or impaired, an entity shall disclose by class of financial asset:
 - a) an analysis of the age of financial assets that are past due as at the reporting date but not impaired;
 - b) an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired; and
 - c) for the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.



2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Liquidity risk

- An entity shall disclose:
 - a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and
 - b) a description of how it manages the liquidity risk inherent in (a).



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2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Market risk

- HKFRS 7 requires the disclosures of sensitivity analysis.
- The disclosures of sensitivity analysis can be achieved by 2 approaches:
 1. Sensitivity analysis for each type of market risk
 2. Sensitivity analysis that reflects interdependencies between risks variables



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2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Market risk – Sensitivity Analysis for Each Type of Market Risk

- An entity shall disclose:
 - a) a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing:
 - how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
 - b) the methods and assumptions used in preparing the sensitivity analysis; and
 - c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

Currency risk,
interest rate risk and
other price risk



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2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Market risk – Sensitivity analysis that reflects interdependencies between risks variables

- Alternatively, an entity prepares and discloses a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g. interest rates and exchange rates) and uses it to manage financial risks.
- The entity shall also disclose:
 - a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and
 - b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

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2. Nature and Extent of Risks

Case

- Early adopted HKFRS 7 in 2005 and its annual report states that (extract only):
 - Risk management techniques, such as Value-at-Risk (“VaR”) based on historical simulation and portfolio stress testing, are used to identify, measure and control foreign exchange risk, equity price risk and interest rate risks of the Group’s investments.
 - VaR measures the expected maximum loss over a given time interval (a holding period of 10 trading days is used by the Group) at a given confidence level (95 per cent confidence interval is adopted by the Group) based on historical data (one year is used by the Group).
 - The Board sets a limit on total VaR of the Group and VaR is monitored on a weekly basis



2. Nature and Extent of Risks

Case

- Early adopted HKFRS 7 in 2005 and its annual report states that (extract only):
 - The VaR for each risk factor and the total VaR of the investments of the Group and HKEx during the year were as follows:



	Group			HKEx		
	2005			2005		
	Average	Highest	Lowest	Average	Highest	Lowest
	\$million	\$million	\$million	\$million	\$million	\$million
Foreign exchange risk	5	6.1	3.6	0.2	0.7	-
Equity price risk	8.5	11.2	6.6	-	-	-
Interest rate risk	20.5	24	14.4	-	-	-
Total VaR	23.5	26.9	20.4	0.2	0.7	-

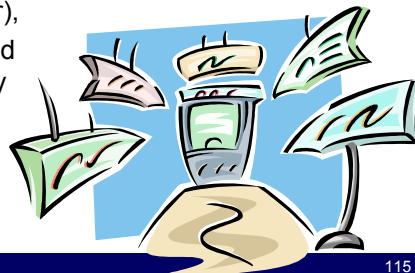
2. Nature and Extent of Risks

Nature and Extent

Quantitative Disclosures

Other market risk disclosures

- When the sensitivity analyses disclosed (by the 2 approaches) are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year),
 - the entity shall disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.



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How Do You Determine Them

Case

Reference to the time horizon and confidence level of some entities used in VaR analysis

<u>Entity name</u>	<u>Time horizon</u>	<u>Confidence level</u>
• HSBC	• 1 day	• 99%
• BoC-HK	• 1 day	• 99%
• Standard Chartered	• 1 day	• 97.5%
• HKMA	• 1 month	• 95%
• HKEx	• 10 days	• 95%

HSBC 

Standard Chartered 

 香港交易所
HKEx

 中國銀行(香港)
BANK OF CHINA (HONG KONG)

 HONG KONG MONETARY AUTHORITY
香港金融管理局

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3. Effective Date and Transition

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

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

A Simple Quantitative Example

Example

Assume you have a financial asset with the following details:

- \$ 10 million in HSBC shares
- Volatility is 2% per day and 32% per year

Find 10-day VaR at 99% confidence level

- The standard deviation of daily changes in the value of the asset is:
2% of \$ 10 million = \$ 200,000
- Assuming the changes on successive days are independent, the standard deviation over 10-day period to be
 $\$ 200,000 \times \sqrt{10} = \$ 632,456$
- 99% confidence level implies $N(-2.33) = 0.01$
- Thus, 10-day 99% VaR for that \$10 million portfolio is:
 $\$632,456 \times 2.33 = \$ 1,473,621$

HKAS 32 & 39 and HKFRS 7 – Part II

28 October 2006



Full set of slides may be found in
www.NelsonCPA.com.hk

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