HKAS 32 & 39 and HKFRS 7 – Part One

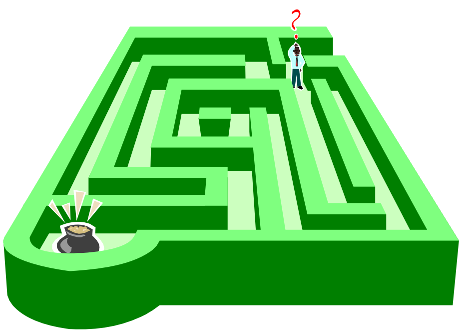
10 March 2008

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

HKAS 32, HKAS 39 and HKFRS 7

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

Professor Sir David Tweedie
Chairman of IASB



HKAS 32, HKAS 39 and HKFRS 7

HKAS 32 ⇒ Disclosure and presentation
HKAS 39 ⇒ Recognition and measurement

- The most interesting standards
- The most lengthiest standards
- The most complex standards
- Cover some unusual or more complex contracts
- But also cover some very simple elements in the financial statements, for example:
  - Cash, trade receivable ……
  - Share capital, trade payable, bank loans ……
- Many additions and amendments as well, including HKFRS 7 ⇒ Disclosure

Main Coverage of HKAS 32 and 39

HKAS 32

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

HKFRS 7 (effective in 2007)

- Disclosure requirements

HKAS 39

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

Today's Agenda

Simple but Comprehensive

Contentious and key issues

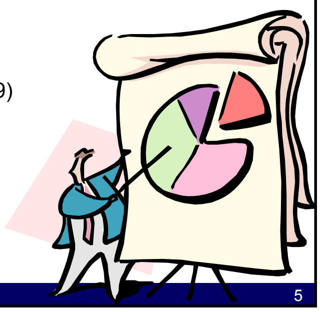
Real Life Cases and Examples

Part One

- Scope
- Definition and Classification
- Initial Recognition and Measurement (HKAS 39)
- Measurement after Recognition (HKAS 39)

Part Two

- Derivatives and Embedded Derviatives (HKAS 39)
- Derecognition (HKAS 39)
- Hedging (HKAS 39)
- Financial Instruments: Presentation (HKAS 32)
- Financial Instruments: Disclosure (HKFRS 7)



Today's Agenda

Part One

- Financial Instruments

Scope	• Extended the scope to all contract to buy and sell of non-financial items that meet the scope.
Definitions	• Financial instruments, including derivatives, are clearly defined.
Initial Recognition	• All financial instruments, including derivatives, are recognised in the balance sheet (on balance sheet).
Measurement	• Except for strict conditions are fulfilled, all financial assets are measured at fair value

Today's Agenda

Part One

Scope

Scope – Excluded from HKAS 32 and 39

HKFRS 7

	HKAS 32	HKAS 39
Interests in subsidiaries, associates and joint ventures accounted for under HKAS 27, 28 and 31	×	×
Rights and obligations under leases to which HKAS 17 applies except for derecognition and embedded derivatives		×
Employers' rights and obligations under employee benefit plans, to which HKAS 19 applies	×	×
Financial instruments issued by the entity that meet the definition of an equity instrument in HKAS 32		×
Rights and obligations under an insurance contract as defined in HKFRS 4, except for embedded derivatives	×	×
Contracts for contingent consideration in a business combination (see HKFRS 3) for the acquirer only	×	×
Contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date		×
Certain loan commitments (HKAS 37 and 18)		×
Instruments and obligations under share-based payment transactions (HKFRS 2), except for some contracts	×	×
Rights to payment to reimburse a recognised provision under HKAS 37		×

Scope – Excluded from HKAS 32 and 39

Example

1. Tony buys a 6-month future contract in oil with a bank over the counter and Tony uses it to hedge with the oil that it would buy in 6 months for his factory.

2. Tony also signs a contract to buy oil from a US oil company and the oil company promises to deliver the oil in 3 months.

Are these two contracts within the scope of HKAS 39?

Scope – Excluded from HKAS 32 and 39

Contracts to buy or sell a non-financial item can be divided into 2 types:

1. that can be settled
   - net in cash or another financial instrument, or
   - by exchanging financial instruments

Forward contracts
- as if financial instruments
- within scope

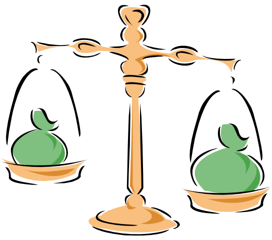
2. that were entered into and continue to be held
   - for the purpose of the receipt or delivery of a non-financial item
   - in accordance with the entity's expected purchase, sale or usage requirements

Usual executory contracts
- **NOT** within scope

Today’s Agenda

Part One

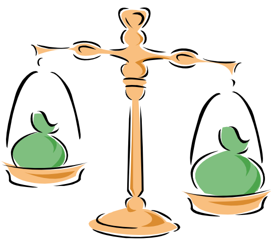
Definitions



Definitions and Classification

A **financial instrument** is any contract that gives rise to

1. a **financial asset** of one entity, and
2. a **financial liability** or **equity instrument** of another equity



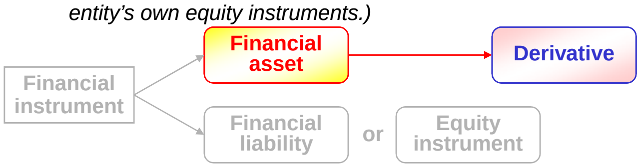
Financial instrument → **Financial asset** ⇒ **of one entity**

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

Definitions – Financial Instruments

Financial asset is any asset that is:

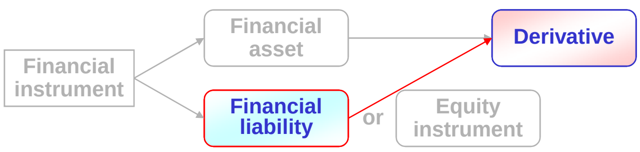
- Cash
- An equity instrument of another entity
- A contractual right
  - i) to receive cash or another financial asset from another entity
  - ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity
- A contract that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



Definitions – Financial Instruments

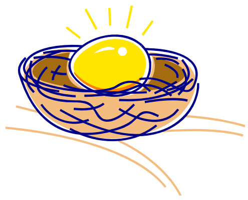
Financial liability is any liability that is

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



Definitions – Financial Instruments

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



Financial instrument → Financial asset / Financial liability or **Equity instrument** — Derivative

Definitions – Financial Instruments

Example

Gold Bullion

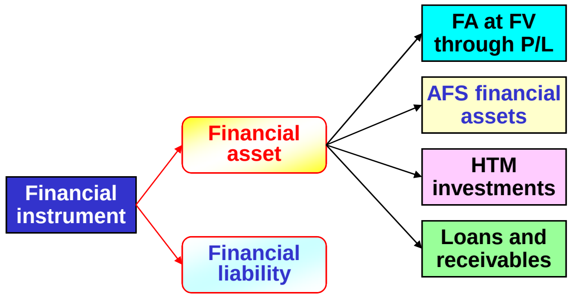
- Is gold bullion a financial instrument (like cash) or is it a commodity?

It is a commodity.

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

Financial instrument → Financial asset / Financial liability or Equity instrument — Derivative

Definitions and Classification



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

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

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

Definitions and Classification

Case

BEA 東亞銀行

Financial instruments – initial recognition (Annual Report 2006)

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

Definitions and Classification

FA at FV through P/L

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

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

a) It is classified as **held for trading**, if it is:

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

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

iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

b) Upon **initial recognition** it is **designated** by the entity as at fair value through profit or loss (only if the entity meets any one of the conditions in HKAS 39)

An entity has NO choice

If an entity meets the condition, it has a choice (since 2006)

Definitions and Classification

Case

China Life Insurance Company Limited

中国人寿 CHINA LIFE

- Accounting report 2006

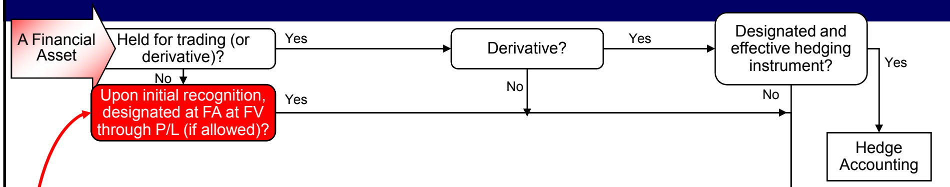
Financial assets at fair value through income

– This category has two sub-categories:
  - financial assets held for trading and
  - those designated at fair value through income at inception.

– A financial asset is classified as held for trading at inception
  - if acquired principally for the purpose of selling in the short term or
  - if it forms part of a portfolio of financial assets in which there is evidence of short term profit-taking.

– Any other additional financial assets may be designated at fair value through income at inception by the Group.
  - The Group presently has no financial assets designated at fair value through income at inception.

Definitions and Classification



Requirements imposed in 2006

– The Fair Value Option (Jul. 2005)

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

3 Conditions to Designate

FA at FV through P/L

Definitions and Classification

FA at FV through P/L

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

Effective from 1.1.2006: Upon initial recognition, an entity may designate a financial asset or financial liability as at fair value through profit or loss only:

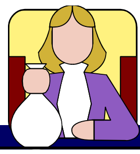
- when permitted by HKAS 39.11A (i.e. in order to avoid separation of embedded derivative from hybrid contract), or
- when doing so results in more relevant information, because either
  - i) it eliminates or significantly reduces a measurement or recognition inconsistency
  - ii) financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis

1. Embedded Derivative Condition

2. Eliminates Inconsistency

3. Managed on Fair Value Basis

3 Conditions to Designate



Definition and Classification

Case

中国建设银行 China Construction Bank

Fair Value Through Profit and Loss (Annual Report 2006)

- Financial assets and financial liabilities are designated at fair value through profit or loss upon initial recognition when:
  - the financial assets or financial liabilities are managed, evaluated and reported internally on a fair value basis;
  - the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise;
  - the financial asset or financial liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract; or
  - the separation of the embedded derivatives from the financial instrument is prohibited.
- All derivatives not qualified for hedging purposes are included in this category and are carried as assets when their fair value is positive and as liabilities when their fair value is negative.

Definitions and Classification

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

Definition – for Available-for-sale financial assets

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

An entity has a choice

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

Definitions and Classification

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

Definition
for Held-to-Maturity Investments

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

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

Definitions and Classification

Example

HTM investments

Definition
for Held-to-Maturity Investments

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

- 5% 5-Year note ⇒ √ HTM investments
- HIBOR 3-Year bank note ⇒ √ HTM investments
- 10% 1-year equity-linked note (at maturity, ABC co. can receive either principal with interest or HSBC shares if the price of HSBC shares falls below $150 each) ⇒ √ but the put option element shall be separated and accounted for as Embedded Derivative *(to be discussed later)*

- **If all these instruments have a quote in an active market, can they be classified as held-to-maturity investments?**

Definitions and Classification

Example

HTM investments

Definition
for Held-to-Maturity Investments

Bond with index-linked interest

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

Yes.
- However, the commodity-indexed or equity-indexed interest payments result in an Embedded Derivative that is separated and accounted for as a derivative at fair value.

Definitions and Classification

Example

HTM investments

Definition
for Held-to-Maturity Investments

Callable bond

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

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

Definitions and Classification

Example

HTM investments

Definition

for Held-to-Maturity Investments

Puttable bond

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

No!

- A financial asset that is puttable (i.e. the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a HTM investment.
- Because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.

Definitions and Classification

Subject to **Tainting Rule** below

HTM investments

Definition

for Held-to-Maturity Investments

An entity shall not classify any financial assets as held to maturity

- if the entity has,
  - during the current financial year or
  - during the two preceding financial years,
  - sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments)

The sales or reclassifications are exempted from the above Tainting Rule if they:

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

Definitions and Classification

Example

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

Definition
for Held-to-Maturity Investments

Sale of HTM investments

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

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

Definitions and Classification

Example

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

Definition
for Held-to-Maturity Investments

Downgrade of Credit Rating

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

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

Definitions and Classification

Example

Subject to Tainting Rule below → HTM investments

Definition for Held-to-Maturity Investments

Different categories of HTM Investments

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

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

No.

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

Definitions and Classification

Example

Subject to Tainting Rule below → HTM investments

Definition for Held-to-Maturity Investments

Different entities in a group

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

No.

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

Definitions and Classification

Case

Hang Seng Bank *(2004 Annual Report)*

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

Explained why!

Why volatility to equity?
to be discussed later

恒 生 銀 行
HANG SENG BANK

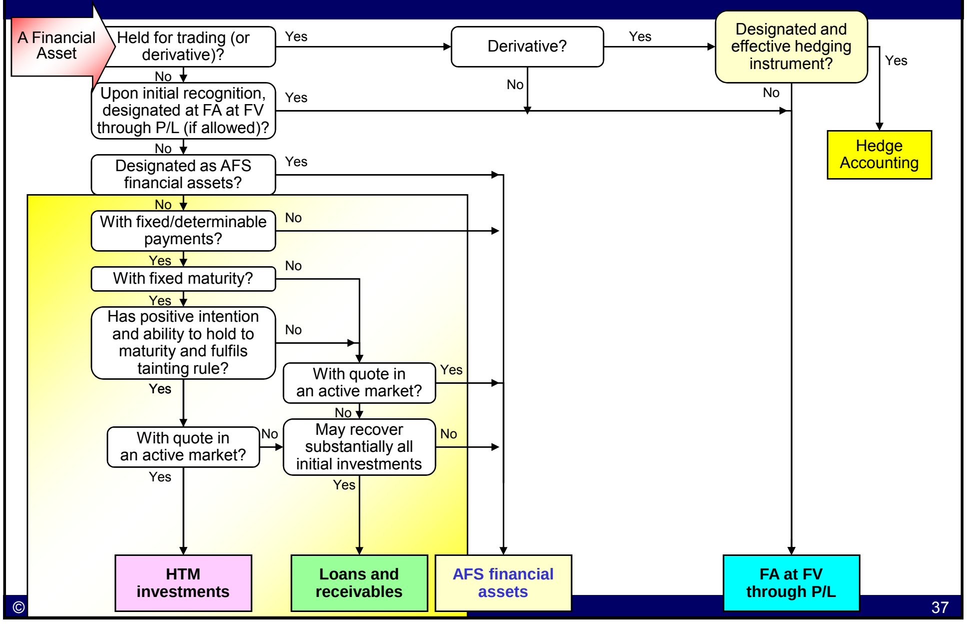
Definitions and Classification

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

Definition

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

Definitions and Classification



Today's Agenda

Part One

Initial Recognition

Measurement

Initial Recognition & Measurement

Financial instrument → Financial asset / Financial liability → Initial Recognition

Initial Recognition: Trade Date Accounting | Regular Way of Financial Assets

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

Initial Recognition & Measurement

Financial instrument → Financial asset / Financial liability → Initial Recognition

Initial Recognition: Trade Date Accounting | Regular Way of Financial Assets

Initial Measurement: Fair Value + Transaction Cost

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

Why?

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

Initial Recognition & Measurement

Financial asset ⟷ Derivative

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

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

Initial Recognition & Measurement

Financial asset ⟷ Derivative

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

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

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

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

Initial Recognition & Measurement

Financial asset ↔ Derivative

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

Initial Recognition & Measurement

Example

Trade Date vs. Settlement Date Accounting

- On 28 June 2011, Entity X agrees to purchase a bond for settlement on 1 July 2011 at $10 million.
- On 30 June 2011, the fair value of the bond is $10.1 million.
- On 1 July 2011, the bond purchase is settled for $10.0 million and the fair value remains as $10.1 million.
- What would be the impact on the balance sheet of the bond purchase at each of the dates of 28 June, 30 June and 1 July?

- The balance sheet impact is shown for both the settlement date approach and the trade date approach.
- The example illustrates initial measurement of the bond purchase under two scenarios:
  1) subsequently carried at fair value (AFS financial assets) and
  2) subsequently carried at amortised cost.

Initial Recognition & Measurement

Example

Trade Date vs. Settlement Date Accounting

	Settlement date accounting		Trade date accounting	
Bond measured at:	*Fair value*	*Amortised cost*	*Fair value*	*Amortised cost*
28 June 2011				
Financial asset - bond	–	–	10.0	10.0
Financial liability	–	–	(10.0)	(10.0)
30 June 2011				
Financial asset - receivable (revaluation gain)	0.1	–	–	–
Financial asset - bond	–	–	10.1	10.0
Financial liability	–	–	(10.0)	(10.0)
Equity	(0.1)	–	(0.1)	–
1 July 2011				
Financial asset - receivable (revaluation gain)	–	–	–	–
Financial asset-bond	10.1	10.0	10.1	10.0
Cash paid	(10.0)	(10.0)	(10.0)	(10.0)
Equity	(0.1)	–	(0.1)	–

Initial Recognition & Measurement

Example

Fair value at Initial Recognition – Low Interest Loan

- Entity A grants a 3-year loan of $50,000 to a related party, B, on 1 Jan. 2005 as one kind of financial assistance to support B's operation.
  - A charges B at a interest rate of 2% as A expects the return on B's future operation would be higher.
  - A charges another related party at a current market lending rate of 6%
- Discuss the implication of the loan.

Fair value at Initial Recognition – No Interest Deposit

- Entity X is required to deposit $50,000 to a customer in order to guarantee that it would complete the service contract in 5 years' time.
- When the contract completes (say after 5 years), the deposit would be refunded in full without any interest.

Initial Recognition & Measurement

Initial Measurement (HKAS 39.AG64)

- The fair value of a financial instrument on initial recognition is normally the **transaction price** (i.e. the fair value of the consideration given or received).
- However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique.
  - For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as
    - the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating.
  - Any additional amount lent is an expense or a reduction of income
    - unless it qualifies for recognition as some other type of asset.

Initial Recognition & Measurement

Case

HSBC

Determination of Fair Value (Annual Report 2006)

- All financial instruments are recognised initially at fair value.
- The fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received.
- In certain circumstances, however, the initial fair value may be based
  - on other observable current market transactions in the same instrument, without modification or repackaging, or
  - on a valuation technique whose variables include only data from observable markets.

Initial Recognition & Measurement

Case

- Accounting report 2006

  Held-to-maturity financial assets

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

Initial Recognition & Measurement

Example

Fair value at Initial Recognition – Low Interest Loan

- Entity A grants a 3-year loan of $50,000 to a related party, B, on 1 Jan. 2005 as one kind of financial assistance to support B's operation.
  – A charges B at a interest rate of 4% as A expects the return on B's future operation would be higher.
  – A charges another related party at a current market lending rate of 6%
- Discuss the implication of the loan.

- On initial recognition, Entity A should recognise the carrying amount of the loan <u>at the fair value</u> of the payments that it <u>will receive</u> from the related party.
- How is the fair value of the payments at initial recognition calculated?

Initial Recognition & Measurement

Example

	Cash inflow	Discount factor	Present value
31.12.2005	\$ 50,000 x 4% = \$ 2,000	$1 / (1 + 6\%)^1$	\$ 1,887
31.12.2006	\$ 2,000	$1 / (1 + 6\%)^2$	\$ 1,780
31.12.2007	\$ 52,000	$1 / (1 + 6\%)^3$	\$ 43,660
		Fair value at initial recognition	*\$ 47,327*

- Discounting the interest and principal repayments using the market rate of 6%, Entity A will recognise an originated loan of $47,327.
- The difference of $ 2,673 is expensed immediately
  - as the expectation about future operating profit of Entity B does not qualify for recognition as an intangible asset.

Initial Recognition & Measurement

Example

Fair value at Initial Recognition

- Entity A grants a loan of $50,000 to a related party, B, on 1 Jan. 2005 as one kind of financial assistance to support B's operation.
  - A expects the return on B's future operation would be higher.
  - However, A has not specified the interest rate and repayment terms with Entity B.
  - A charges another related party at a current market lending rate of 6%
- Discuss the implication of the loan.

Initial Recognition & Measurement

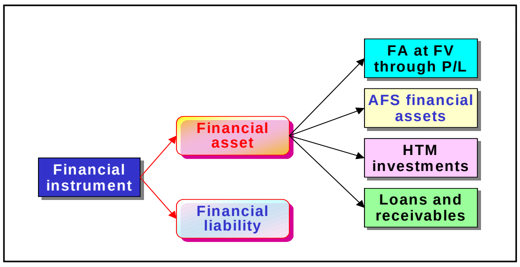
No Active Market: Valuation Technique (HKAS 39.AG79)

- Short-term receivables and payables with no stated interest rate may be measured
  - at the original invoice amount if the effect of discounting is immaterial.

- Implies, no matter it is receivable from related party, or interest-free
  - No discounting may be required
  - Effective interest estimates (imputed interest) may be required
- Can management argue it is "repayable on demand", even they expect that it would not be repaid soon?
  - Is it an estimate or judgement issue?

Today's Agenda

Part One



Measurement

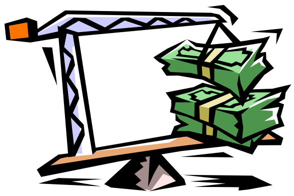
- **Financial Assets – Subsequent Measurement**

Measurement after Recognition

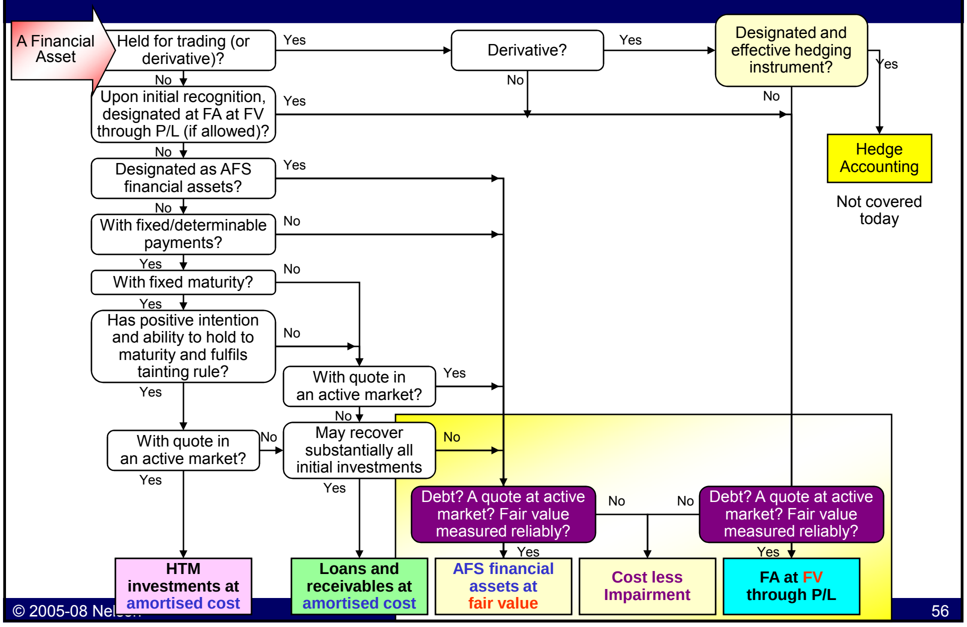
Classification determine
Subsequent Measurement

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

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



Measurement after Recognition



Measurement after Recognition

Subsequent Measurement

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

Measurement after Recognition

Subsequent Measurement

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

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

Measurement after Recognition

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

Active market exists

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

 59

Measurement after Recognition

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

No active market

- An entity establishes fair value by using a valuation technique
- To establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations
- Valuation techniques include
  - Using recent arm's length market transactions between knowledgeable, willing parties
  - Discounted cash flow analysis
  - Option pricing models

- Can NAV of an unlisted entity be considered as fair value?
- It is much like a finance question …… yes & no

 60

Measurement after Recognition

Example

Fair Value of Quoted Price

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

No.

- The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in HKAS 39 to use the current bid price in the absence of a matching liability position.
- In its financial statements, an investment fund measures its assets at current bid prices.
- In reporting its net asset value to investors, an investment fund may wish to provide a reconciliation between the fair values recognised on its balance sheet and the prices used for the net asset value calculation.

Measurement after Recognition

Case

Li & Fung Limited

- In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:
  - The fair values of quoted investments are based on current bid prices.
  - If the market for a financial asset is not active (and for unlisted securities), the Group establishes fair value by using valuation techniques. These include
    - the use of recent arm's length transactions,
    - reference to other instruments that are substantially the same,
    - discounted cash flow analysis, and
    - option pricing models refined to reflect the issuer's specific circumstances.

Measurement after Recognition

Subsequent Measurement

FA at FV through P/L	at Fair Value	
AFS financial assets	at Fair Value at Cost	⇨ For investments in equity instruments that • do not have a quoted market price in an active market, and • whose fair value cannot be reliably measured – Included those derivatives that are linked to and must be settled by delivery of such quoted equity instruments
HTM investments	at Amortised Cost	
Loans and receivables	at Amortised Cost	

Measurement after Recognition

Subsequent Measurement

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

Amortised cost of a financial instrument is:

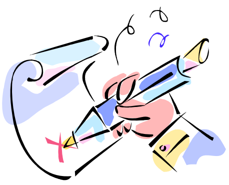
- the amount at which the financial instrument is measured at initial recognition
- minus principal repayments,
- plus or minus the cumulative amortisation using **the effective interest method** of any difference between that initial amount and the maturity amount, and
- minus any reduction (directly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

Measurement after Recognition

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

Measurement after Recognition

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



Measurement after Recognition

Case

Hang Seng Bank *(2004 Annual Report)*

Loan fee income and costs

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

恒生銀行 HANG SENG BANK

Measurement after Recognition

Example

Amortised Cost on Low Interest Loan

- Followed on same previous example, Entity A grants a 3-year loan of \$50,000 to an important new customer in 1 Jan. 2005
  - The interest rate on the loan is 4%
  - The current market lending rates for similar loans is 6%
- Entity A believes that the future business to be generated with this new customer will lead to a profitable lending relationship.
- On initial recognition, Entity A recognised \$47,327 (as calculated below):

	Cash inflow	Discount factor	Present value
31.12.2005	\$ 50,000 x 4% = \$ 2,000	$1 / (1 + 6\%)^1$	\$ 1,887
31.12.2006	\$ 2,000	$1 / (1 + 6\%)^2$	\$ 1,780
31.12.2007	\$ 52,000	$1 / (1 + 6\%)^3$	\$ 43,660
		Fair value at initial recognition	*\$ 47,327*

- Calculate the amortised cost each year end.

Measurement after Recognition

Example

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

- For example, at 31.12.2005, the entry is:

Dr	Loans receivable ($47,327 x 6%)	2,840	
Cr	Interest income (P/L)		2,840
	Being effective interest income recognised for the year.		
Dr	Cash (interest received, $50,000 x 4%)	2,000	
Cr	Loans receivable		2,000
	Being cash interest received.		

Measurement – Impairment

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

Impairment

At each balance sheet date

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

Measurement – Impairment

Outside the scope of HKAS 36

Conditions for Impairment

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

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

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

AFS financial assets

HTM investments

Loans and receivables

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

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

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

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

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

Sequence of Impairment Assessment

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

Measurement – Impairment

Case

恒 生 銀 行
HANG SENG BANK

- 2004 Annual Report states:
  - It is the Group's policy to make provisions for bad and doubtful debts promptly where required and on a prudent and consistent basis.
  - There are two basic types of provisions, specific and general, each of which is considered in terms of the charge and the amount outstanding.

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

Measurement – Impairment

Example

Amortised Cost on Low Interest Loan

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

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

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

Measurement – Impairment

Example

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

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

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

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

FA at FV through P/L — at Fair Value

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

HTM investments

Loans and receivables

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

Measurement – Impairment

Outside the scope of HKAS 36

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

Impairment (if there is objective evidence)

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

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

Implication?

Measurement – Impairment

Example

Impairment reserves

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

No.

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

Measurement – Impairment

Example

Impairment at Initial Recognition

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

No.

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

Measurement – Impairment

Example

Impairment Based on Ageing Analysis

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

Not necessarily.

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

Measurement – Impairment

Example

Impairment on Portfolio Basis

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

No.

- If an entity knows that an individual financial asset carried at amortised cost is impaired, HKAS 39 requires that the impairment of that asset should be recognised.
- HKAS 39 states: "the amount of the loss is measured as the difference between ***the asset's*** carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate".
- Measurement of impairment on a portfolio basis under HKAS 39 may be applied to groups of small balance items and to financial assets that are individually assessed and found not to be impaired when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

Measurement – Impairment

Example

Aggregate Fair Value Less Than Carrying Amount

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

Not necessarily.

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

Measurement – Impairment

Case

Standard Chartered

Accounting policy on impairment of available-for-sale assets (from 2005):

- A significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the assets are impaired.
  - If any such evidence exists for available-for-sale financial assets, the cumulative loss (measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss) is removed from equity and recognised in the income statement.
- Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.
- If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through the income statement.

Measurement – Impairment

Outside the scope of HKAS 36

Impairment ← Is Reversal allowed?

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

Impairment losses on **equity instrument**
- shall **NOT be reversed** through profit or loss.

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

Measurement – Impairment

Outside the scope of HKAS 36

Impairment ← Is Reversal allowed?

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

Such impairment losses shall NOT be reversed

Measurement – Impairment

Outside the scope of HKAS 36

Impairment ← Is Reversal allowed?

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

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

Measurement – Reclassification

Reclassification

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

An entity shall NOT reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.

Measurement – Reclassification

Reclassification

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

A change in intention or ability

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

Tainting rule triggered

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

Measurement – Reclassification

Reclassification

FA at FV through P/L — at Fair Value

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

HTM investments — at Amortised Cost

Loans and receivables — at Amortised Cost

If a reliable measure becomes available on fair value

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

Measurement – Reclassification

Reclassification

FA at FV through P/L — at Fair Value

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

HTM investments — **at Amortised Cost**

Loans and receivables — at Amortised Cost

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

Measurement – Reclassification

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

Reclassification

- The fair value carrying amount of the asset on that date becomes its new cost or amortised cost, as applicable
- Any previous gain or loss on that asset that has been recognised directly in equity shall be accounted for as follows:
  a) In the case of a financial asset with a fixed maturity
    - the gain or loss shall be amortised to P/L over the remaining life of the HTM investment using the effective interest method.

  b) In the case of a financial asset that does not have a fixed maturity
    - the gain or loss shall remain in equity until the financial asset is sold or otherwise disposed of, when it shall be recognised in P/L.

Measurement – Summary

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

Measurement – Current or Non-Current

HKAS 39

Classified to Current or Non-Current?

Refer to HKAS 1 as well

- Held for trading
- Designated initially

→ **FA at FV through P/L** → **Current** / **Non-Current**

- Designated initially

→ **AFS financial assets** → **Current** / **Non-Current**

Tax Implication?

- Not clearly defined

→ **Loans and receivables** → **Current** / **Non-Current**

- Intention to hold to maturity
- When will it be matured?

→ **HTM investments** → **Current** / **Non-Current**

Measurement – Current or Non-Current

Case

Li & Fung Limited

- In its 2006 Annual Report, full set of HKFRS was adopted and the report set out that:
  - Available-for-sale financial assets are non-derivatives that are either
    - designated in this category or
    - not classified in any of the other categories.
  - They are included in non-current assets
    - unless management intends to dispose of the investment within 12 months of the balance sheet date.

Is it current?

Measurement – Current or Non-Current

- HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* states (HKFRS 5.3) that:
  - Assets classified as non-current in accordance with HKAS 1 *Presentation of Financial Statements* shall not be reclassified as current assets
    - until they meet the criteria to be classified as held for sale in accordance with this HKFRS.
  - Assets of a class that an entity would normally regard as non-current that are acquired exclusively with a view to resale shall not be classified as current
    - unless they meet the criteria to be classified as held for sale in accordance with this HKFRS.
  - They are included in non-current assets
    - unless management intends to dispose of the investment within 12 months of the balance sheet date.

Is it current?

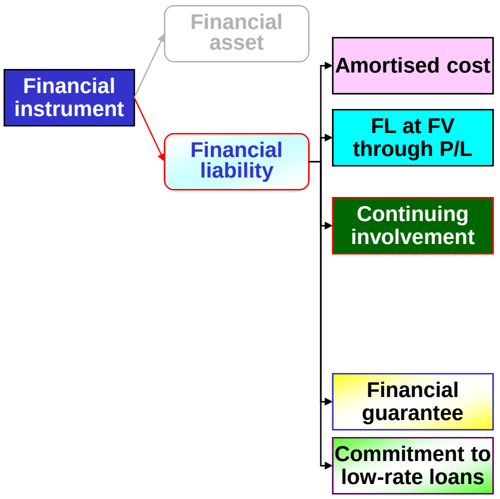
Today's Agenda

Part One

Measurement

- **Financial Liabilities – Subsequent Measurement**

Financial Liabilities – Measurement



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

a) financial liabilities at fair value through profit or loss
b) financial liabilities that arise
   - when a transfer of a financial asset does not qualify for derecognition, or
   - when the continuing involvement approach applies.
c) Financial guarantee contracts
d) Commitments to provide a loan at a below-market interest rate.

Financial Liabilities – Measurement

Amortised cost

- Amortised cost
  - As those discussed in financial assets

FL at FV through P/L

- Financial liabilities at fair value through profit or loss
- Similar to financial asset at fair value through profit or loss
  - Those held for trading — Entity has NO choice
    - Acquired principally for selling in the near term
    - Recent actual short-term profit taking
    - Derivatives that are liabilities (except for hedging instruments)
  - Those designated (if allowed) — Entity has a choice
- Excluded those unquoted and fair value cannot be reliably measured
- If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability

Continuing involvement

- Financial liabilities that arise when
  - a transfer of a financial asset **does not qualify for derecognition**, or
  - when the **Continuing Involvement Approach** applies

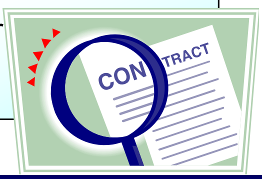
Financial Liabilities – Measurement

Financial guarantee

Commitment to low-rate loans

- Financial guarantee contract is defined in HKAS 39 as a contract that:
  - requires the issuer to make specified payments to reimburse the holder for a loss it incurs
  - because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

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



Financial Liabilities – Measurement

Financial guarantee

Commitment to low-rate loans

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

Initial Recognition

Trade Date Accounting | **Regular Way of Financial Assets**

↓

Initial Measurement

Fair Value

+

Transaction Cost

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

Financial Liabilities – Measurement

Financial guarantee

Commitment to low-rate loans

After initial recognition,

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

Financial Liabilities – Measurement

Financial guarantee

Asserted Explicitly

Used Insurance Accounting

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

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

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

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

Financial Liabilities – Measurement

Case

Financial guarantee

Jardine Matheson

- 2006 Annual Report
  - Financial guarantee contracts under which the Group accepts significant risk from a third party by agreeing to compensate that party on the occurrence of a specified uncertain future event
    - are accounted for in a manner similar to insurance contracts.
  - Provisions are recognized when
    - it is probable that the Group has obligations under such guarantees and
    - an outflow of resources embodying economic benefits will be required to settle the obligations.

Financial Liabilities – Measurement

Case

Financial guarantee

Tristate Holdings Limited

- 2006 Annual Report
  - For guarantees provided by the Company for banking facilities granted to subsidiaries, the Company
    - regards such guarantees as insurance contracts and does not recognise liabilities for financial guarantees at inception,
    - but performs a liability adequacy test at each reporting date and recognise any deficiency in the liabilities in the income statement.

Financial Liabilities – Measurement

Financial guarantee

- HKFRS 4 *Insurance Contracts*:

  Liability adequacy test (HKFRS 4.15)
  - An insurer shall assess at each reporting date whether its recognised insurance liabilities are adequate,
    - using current estimates of future cash flows under its insurance contracts.
  - If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32) is inadequate in the light of the estimated future cash flows,
    - the entire deficiency shall be recognised in profit or loss.

Financial Liabilities – Measurement

Case

Recruit 才庫媒體集團有限公司

Annual Report 2006 – Note 3.20 clarified that

- A financial guarantee contract is
  - a contract that requires the issuer (or guarantor) to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument.
- Where the Group issues a financial guarantee, the fair value of the guarantee is initially recognised as deferred income within trade and other payables.
  - Where consideration is received or receivable for the issuance of the guarantee, the consideration is recognised in accordance with the Group's policies applicable to that category of asset.

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

    Dr Profit & loss
    Cr Payables

Financial Liabilities – Measurement

Case

Annual Report 2006 – Note 3.20 clarified that

- The amount of the guarantee initially recognised as deferred income
  - is amortised in income statement over the term of the guarantee as income from financial guarantees issued.
- In addition, provisions are recognised if and when
  - it becomes probable that the holder of the guarantee will call upon the Group under the guarantee and
  - the amount of that claim on the Group is expected to exceed the current carrying amount, i.e. the amount initially recognised less accumulated amortisation, where appropriate.

Dr Payables
Cr Profit & loss

Dr Profit & loss
Cr Payables

Financial Liabilities – Measurement

Case

How much did it have …….

Annual Report 2006 – Note 36 set out:

	Group 2006 HK$'000	Group 2005 HK$'000	Company 2006 HK$'000	Company 2005 HK$'000
Corporate guarantees given and utilised*	–	–	14,000	16,000

* As at 31 December 2006, the Company has given corporate guarantees to its non wholly owned subsidiary to the extent of HK$24,700,000 (2005: HK$33,060,000) in relation to payments for certain finance leases to financial institutions as set out in Note 27 to the financial statements, HK$14,000,000 (2005: HK$16,000,000) of which was utilised.

Most critical ….. "In the opinion of the directors of the Company,

- no material liabilities will arise from the above guarantees which arose in the ordinary course of business and
- the fair value of the corporate guarantees granted by the Company is immaterial.

HKAS 32 & 39 and HKFRS 7 – Part One

10 March 2008

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

Nelson Lam 林智遠
nelson@nelsoncpa.com.hk
www.nelsoncpa.com.hk

HKAS 32 & 39 and HKFRS 7 – Part One

10 March 2008

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

Nelson Lam 林智遠
nelson@nelsoncpa.com.hk
www.nelsoncpa.com.hk

