HKAS 32, HKAS 39 and HKFRS 7
(Part 1)

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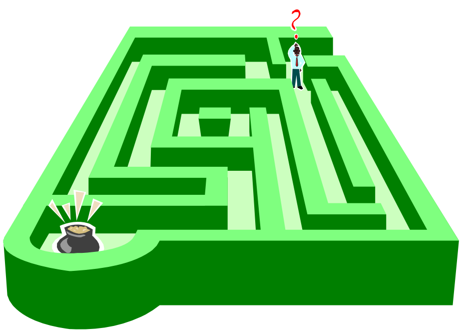
HKAS 32, HKAS 39 and HKFRS 7

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

Professor Sir David Tweedie
Chairman of IASB



Main Coverage

HKAS 32

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

HKFRS 7

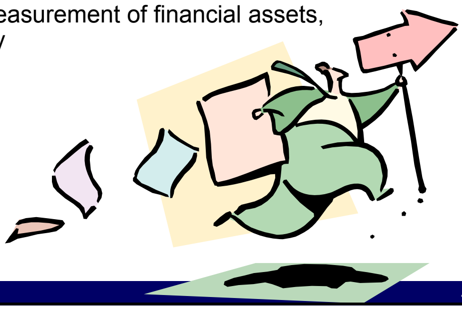
- Disclosure requirements

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

Scope	• Extended the scope to all contract to buy and sell of non-financial items that meet the scope.
Initial Recognition	• All financial instruments, including derivatives, are recognised in the balance sheet (on balance sheet).
Classification of Fin. Assets	• Classification of financial assets
Measurement of Fin. Assets	• Subsequent measurement of financial assets, financial liability
Financial Liabilities	



Today's Agenda

Scope

- Extended the scope to all contract to buy and sell of non-financial items that meet the scope.

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

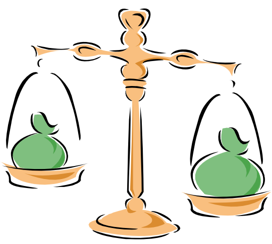
Forward contracts
- as if financial instruments
- within scope

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

Scope – What is Financial Instrument?

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



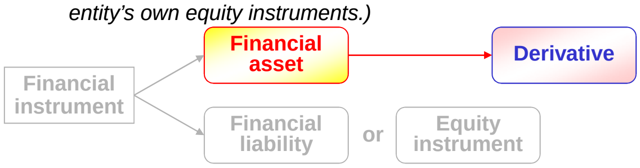
Financial instrument → **Financial asset** → **of one entity**

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

Scope – What is Financial Instrument?

Financial asset is any asset that is:

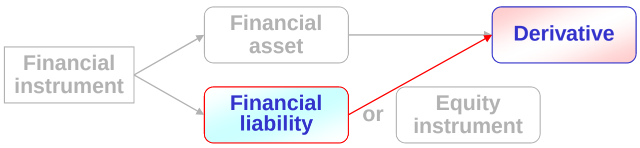
- Cash
- An equity instrument of another entity
- A contractual right
  - i) to receive cash or another financial asset from another entity
  - ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity
- A contract that 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.)*



Scope – What is Financial Instrument?

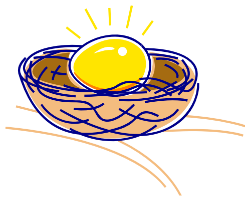
Financial liability is any liability that is

- 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.)*



Scope – What is Financial Instrument?

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

Scope – What is Financial Instrument?

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

Today's Agenda

Initial Recognition

- All financial instruments, including derivatives, are recognised in the balance sheet (on balance sheet).

Initial Recognition & Measurement

- Initial recognition requirements for financial assets and financial liabilities in HKAS 39 are the same.
- An entity is required to recognise a financial asset or a financial liability on its balance sheet when, and only when, <u>the entity becomes a party to the contractual provisions of the instrument</u>.
- In other accounting standards, the recognition criteria are
  1) it is probable that future economic benefits associated with the item will flow to (or flow out from) the entity; and
  2) the cost of the item can be measured reliably.

Imply trade date accounting

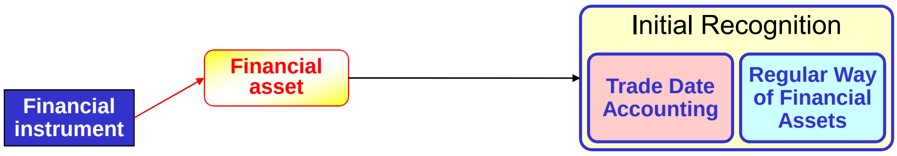
Imply settlement date accounting

Financial instrument → Financial asset

Financial instrument → Financial liability

Initial Recognition & Measurement

- For financial assets, an entity can choose to recognise and derecognise a financial asset either using trade date accounting or settlement date accounting <u>if it is a regular way purchase or sale of financial asset</u>
- A <u>regular way purchase or sale</u> 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.



Initial Recognition & Measurement

- HKAS 39 specifically states that a contract that requires or permits <u>net settlement</u> of the change in the value of the contract (such as derivative contract) is not a regular way contract.
  - Such contract is accounted for as a derivative in the period between the trade date and the settlement date.
- No matter which accounting method is used for a regular way purchase or sale, the method used is <u>applied consistently</u> for all purchases and sales of financial assets that belong to the same category of financial assets.

Initial Recognition & Measurement

- For both financial assets and financial liabilities, HKAS 39 has
  - the same initial recognition requirements
  - the same initial measurement basis
- When a financial asset or financial liability (except for it at fair value through profit or loss) is recognised initially, an entity is required to measure it at:
  1. its **fair value** plus
  2. its **transactions costs** that are directly attributable to the acquisition or issue of the financial asset or financial liability

Initial Recognition & Measurement

- In the case of a financial asset or financial liability that will be classified as financial asset or financial liability at fair value through profit or loss,
  - an entity is only required to measure it at its fair value only
  - its transaction costs should not be recognised.

Initial Recognition & Measurement

- Fair value
  - is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
- Transaction costs
  - are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.
  - An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

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

- Accounting report 2006

  Held-to-maturity financial assets

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

Initial Recognition & Measurement

Example

- Advance Finance Inc. grants a 3-year loan of $50,000 to a new customer on 1 January 2008.
- Advance Finance Inc. charges the interest at 4% per annum as it expects to generate more new business from this new customer.
- The current market lending rate of a similar loan is 6% per annum.
- Discuss the implication of the loan.

Initial Recognition & Measurement

Example

- On initial recognition, Advance Finance Inc. should recognise the loan receivable at the fair value.
- Even the best evidence of the fair value of the loan at initial recognition is the transaction price but part of the consideration given is for something other than the loan, the fair value of the loan should be estimated using a valuation technique.
- The fair value of the loan receivable can be estimated as the present value of all future cash receipts discounted using the prevailing market interest rate for a similar instrument.
- By using the market interest rate of 6% for a similar loan, Advance Finance Inc. derives the present value of the interests and principal repayments as follows:

	Cash inflow	Discount factor	Present value
2008	$ 2,000	$1 \div (1+6\%)^1$	$ 1,887
2009	2,000	$1 \div (1+6\%)^2$	1,780
2010	2,000	$1 \div (1+6\%)^3$	1,679
2010	50,000	$1 \div (1+6\%)^3$	41,981
Present value of all future cash receipts			47,327

Initial Recognition & Measurement

Example

- Discounting the interest and principal repayments using the market rate of 6%, Advance Finance Inc. will recognise an originated loan of $47,327. The difference of $2,673 between $50,000 and $47,327 may represent the value of future business with the customer. However, it does not qualify for recognition as an asset and should be expensed immediately. Advance Finance Inc. recognises the loan receivable as follows:

Dr	Financial asset	$47,327	
	Profit or loss	2,673	
Cr	Cash		$50,000

Today's Agenda

Classification

- Classification of financial assets, financial liability and equity

Classification and Definitions

Financial instrument → Financial asset; Financial liability

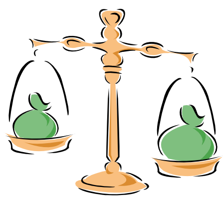
Financial asset → FA at FV through P/L; AFS financial assets; Loans and receivables; HTM investments

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

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

Classification and Definitions



- For the purpose of our discussion, five categories are used and explained for subsequent measurement of financial assets
  - Financial assets at fair value through profit or loss
  - Available-for-sale financial assets
  - Investments in equity instruments without fair value
  - Loans and receivables
  - Held-to-maturity investments

The categories named in HKAS 39

FA at FV through P/L

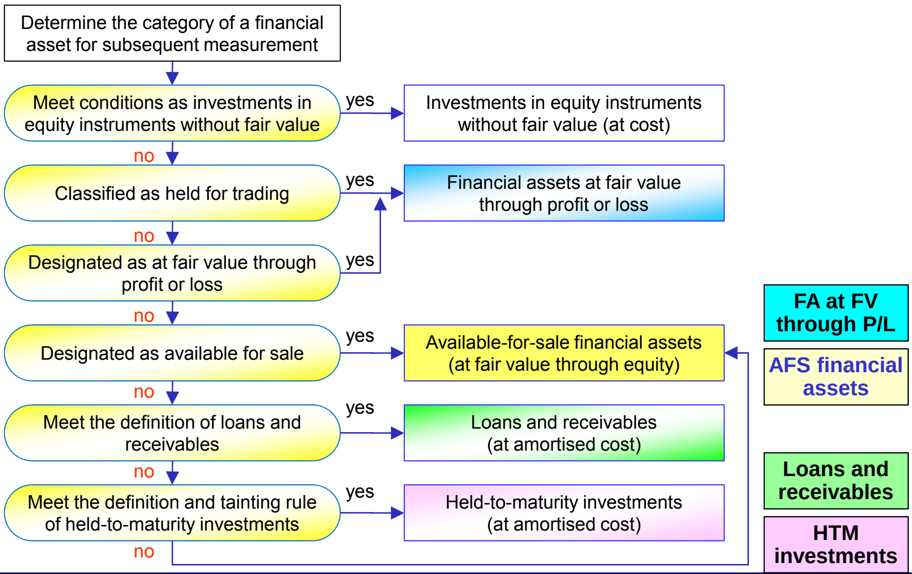
AFS financial assets

Loans and receivables

HTM investments

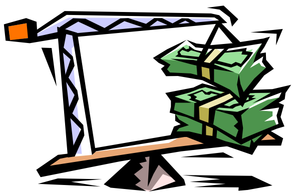
Sourced from Intermediate Financial Reporting (2008) by Nelson Lam and Peter Lau

Classification and Definitions



Classification and Definitions

- Even the requirements of HKAS 39 imply that the category of a financial asset determines the subsequent measurement of the financial asset,
  – an entity can choose to use all or some of the categories.
- Implicitly from the definitions and reclassification requirements in HKAS 39,
  – an entity has to determine the category of its financial asset at initial recognition.



FA at FV through P/L

AFS financial assets

Loans and receivables

HTM investments

Classification and Definitions

Determine the category of a financial asset for subsequent measurement

Meet conditions as investments in equity instruments without fair value

3 conditions to qualify as investments in equity instruments without fair value:
1. The asset is an equity instrument
2. No active market for the asset
3. Fair value of the asset cannot be reliably measured

- No financial assets can be measured at cost
  – unless the financial asset is an investment in equity instrument that meets all the above three conditions.
- The category of "investments in equity instruments"
  – Also includes the derivatives that are linked to and must be settled by delivery of such unquoted equity instruments
  – Such derivatives are also measured at cost.

FA at FV through P/L

AFS financial assets

Loans and receivables

HTM investments

Classification and Definitions

Fair Value Measurement Consideration

- Fair value is defined in HKAS 39 and the same definition is used for both initial measurement and subsequent measurement.
- In determining whether there is a fair value for a financial instrument for subsequent measurement (whether it can be reliably measured),
  – HKAS 39 implies a hierarchy for the determination of fair value that an entity is required to apply.
  – The hierarchy refers to
    1. the existence of active market, and
    2. no existence of active market.

Active Market

No Active Market

FA at FV through P/L

AFS financial assets

Loans and receivables

HTM investments

Classification and Definitions

Fair Value Measurement Consideration — Active Market

- The best evidence of fair value
  - is quoted prices in an active market.
- Quote is in an active market
  - If quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

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

Classification and Definitions

Fair Value Measurement Consideration — Active Market

- Different kinds of quoted market price would be used as reference in the following manner:
  - For a financial asset held or a financial liability to be issued
    - ➢ is usually the current bid price.
  - For a financial asset to be acquired or a financial liability held
    - ➢ is usually the asking price.
  - When an entity has assets and liabilities with offsetting market risks,
    - ➢ it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate.
  - When current bid and asking prices are unavailable,
    - ➢ the price of the most recent transaction provides evidence of the current fair value

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

Classification and Definitions

Fair Value Measurement Consideration — No Active Market

- If there is no quotation of an active market for a financial instrument or part of the consideration given or received in the transaction is for something other than the financial instrument,
  - the fair value of the financial instrument is estimated using a valuation technique.

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

Classification and Definitions

Fair Value Measurement Consideration — No Active Market

- Valuation techniques for financial instruments specified in HKAS 39 include:
  - using recent arm's length market transactions between knowledgeable, willing parties, if available,
  - reference to the current fair value of another instrument that is substantially the same,
  - discounted cash flow analysis and
  - option pricing models.
- If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions,
  - the entity uses that technique.

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

Classification and Definitions

Case

Standard Chartered

Accounting policy 2007

- The fair values of quoted investments in active markets 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,
  - discounted cash flow analysis,
  - option pricing models and
  - other valuation techniques commonly used by market participants.

Classification and Definitions

Fair Value Measurement Consideration — No Active Market

- When an investment in equity instrument can be classified as "investment in equity instrument without fair value",
  - it implies that, after the application the hierarchy for the determination of fair value, the entity is still unable to reliably measure the equity instrument.
- HKAS 39 further explains that the fair value of investments in equity instruments that do not have a quoted market price in an active market is still reliably measurable if
  1. The variability in the range of reasonable fair value estimates is not significant for that instrument or
  2. The probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

FA at FV through P/L

AFS financial assets

Loans and receivables

HTM investments

 Sourced from Intermediate Financial Reporting (2008) by Nelson La

Classification and Definitions

- The definition of the category of "financial assets at fair value through profit or loss" is comparatively complicated.
  - Firstly, HKAS 39 formally describes this classification as "financial asset or financial liability at fair value through profit or loss" and
    - implies that the same definition of classification can be applied to both financial assets and financial liabilities.
  - Secondly, the definition of this classification requires that
    - certain financial <u>instruments "held for trading" must be classified as "fair value through profit or loss</u>", and
    - an entity is allowed <u>to choose to designate certain other financial instruments as "fair value through profit or loss" at their initial recognition</u>.

FA at FV through P/L

Held for trading

Designation

Classification and Definitions

Determine the category of a financial asset for subsequent measurement

Meet conditions as investments in equity instruments without fair value

no

Classified as held for trading

Three situations to be held for trading:

1. Principally for the purpose of selling or repurchasing it in the near term
2. Evidence of a recent actual pattern of short-term profit-taking
3. A derivative (not being financial guarantee contact nor designated and effective hedging instrument)

FA at FV through P/L

Held for trading

Classification and Definitions

Determine the category of a financial asset for subsequent measurement

Meet conditions as investments in equity instruments without fair value

no

Classified as held for trading

no

Designated as at fair value through profit or loss

To meet 3 conditions for initial designation as at fair value through profit or loss:

1. Embedded derivative condition
2. Accounting mismatch condition
3. Risk management condition

FA at FV through P/L

- When an entity chooses to use this fair value option and designates a financial instrument as at fair value through profit or loss,
  – it must make such designation at initial recognition of the financial instruments and meet at least any one of the above three conditions set out in HKAS 39.

Designation

Classification and Definitions

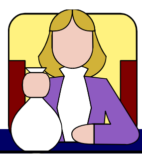
Upon initial recognition, an entity may designate a financial asset or financial liability as at fair value through profit or loss only:

- when permitted by paragraph 11A of HKAS 39 (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



Classification and Definitions

Case

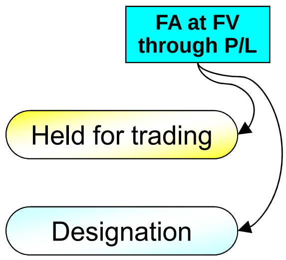
中国建设银行
China Construction Bank

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.

Classification and Definitions

- When an entity has chosen to apply fair value option to a financial asset,
  - the definition of the fair value option additionally imposes strict requirements on measurement and disclosure.
- The definition of financial asset at fair value through profit or loss specifically requires that
  - an entity is not allowed to designate any investments in equity instruments without fair value as at fair value through profit or loss.
- It also describes that requirements for determining a reliable measure of the fair value of a financial asset, apply equally to all items that are measured at fair value, whether by designation or otherwise, or whose fair value is disclosed.
- Additional disclosure is also found in HKFRS 7.



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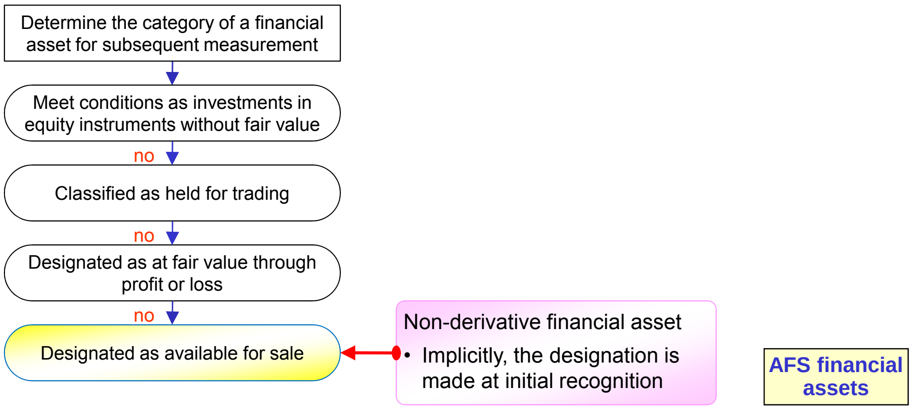
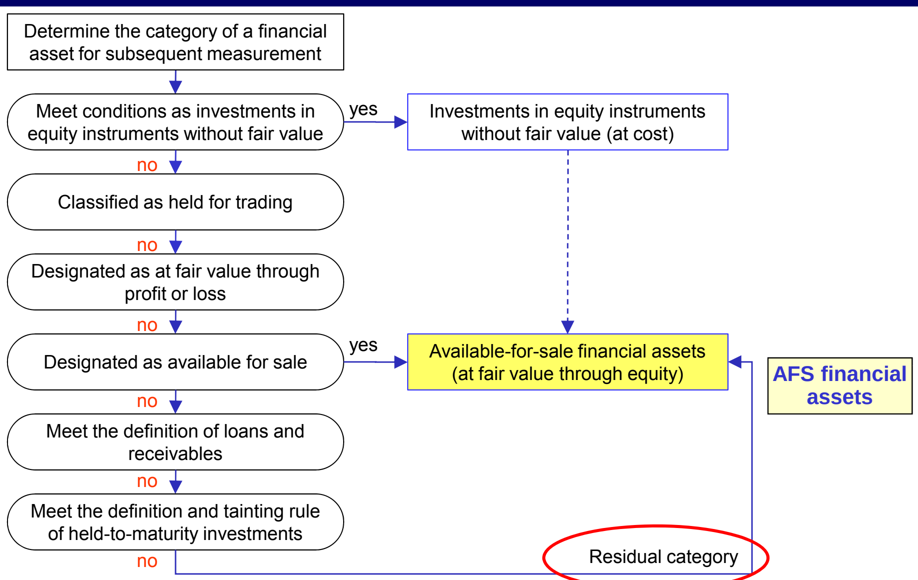
Classification and Definitions



Classification and Definitions



Classification and Definitions

- Available-for-sale financial assets are those non-derivative financial assets that
  - are designated as available for sale or
  - are not classified as
    1. Loans and receivables,
    2. Held-to-maturity investments or
    3. Financial assets at fair value through profit or loss.

AFS financial assets

Classification and Definitions

Determine the category of a financial asset for subsequent measurement

Meet conditions as investments in equity instruments without fair value

no

Classified as held for trading

no

Designated as at fair value through profit or loss

no

Designated as available for sale

no

Meet the definition of loans and receivables

- Non-derivative financial asset
- With fixed or determinable payments
- Not quoted in an active market
- Other than those for which the holder may not recover substantially all of its initial investment

Loans and receivables

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

Classification and Definitions

- Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:
  1. those that the entity intends to sell immediately or in the near term, which shall be classified as "held for trading", and those that the entity upon initial recognition designates as at "fair value through profit or loss";
  2. those that the entity upon initial recognition designates as "available for sale"; or
  3. those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as "available for sale".

  An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.

Loans and receivables

Classification and Definitions

Example

Classification of Investment in Preference Share

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

Yes.

- If a non-derivative equity instrument would be recorded as a liability by the issuer, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holder, provided the definition is otherwise met.
- HKAS 32 provides guidance about the classification of a financial instrument as a liability or as equity from the perspective of the issuer of a financial instrument.
- If an instrument meets the definition of an equity instrument under HKAS 32, it cannot be classified within loans and receivables by the holder.

Classification and Definitions

Determine the category of a financial asset for subsequent measurement

↓

Meet conditions as investments in equity instruments without fair value

no ↓

Classified as held for trading

no ↓

Designated as at fair value through profit or loss

no ↓

Designated as available for sale

no ↓

Meet the definition of loans and receivables

no ↓

Meet the definition and tainting rule of held-to-maturity investments ←

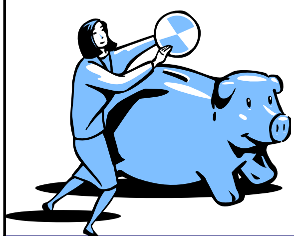
- Non-derivative financial asset
- Fixed or determinable payments
- Fixed maturity
- Positive intention and ability to hold to maturity
- Other than those classified in other categories
- Meet the "tainting rule" and does not trigger any restriction

HTM investments

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

Classification and Definitions

- Held-to-maturity investments are defined as:
  - non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than:
    1. those that the entity upon initial recognition designates as at "fair value through profit or loss";
    2. those that the entity designates as "available for sale"; and
    3. those that meet the definition of "loans and receivables".



HTM investments

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

Classification and Definitions

Meeting the Definition of Loans and Receivables

- While both loans and receivables and held-to-maturity investments are non-derivative financial assets with fixed or determinable payments, their differences are that:
  - Fixed maturity is required for held-to-maturity investments but not required for loans and receivable.
  - Positive intention and ability to hold to maturity investments is required for held-to maturity investments but not required for loans and receivables.
  - Loans and receivables cannot be a financial asset for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration.
  - Loans and receivables must not be quoted in an active market but such requirement is not imposed on held-to-maturity investments.
  - Loans and receivables are not subject to tainting rule, which is applied to held-to-maturity.

HTM investments

Classification and Definitions

Case

CIIH
中保國際控股有限公司
China Insurance International Holdings Company Limited

- Accounting report 2006

Held-to-maturity securities

– Dated debt securities that the group and/or the company have
  - o the positive ability and
  - o intention to hold to maturity

  are classified as held-to-maturity securities.

– Held-to-maturity securities are stated in the balance sheet at amortised cost less impairment losses ……

Classification and Definitions

Example

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.

Classification and Definitions

Tainting Rule

- 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)
    - other than sales or reclassifications that:
      i. are so close to maturity or the financial asset's call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
      ii. occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or
      iii. 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.

HTM investments

Classification and Definitions

Example

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.

Classification and Definitions

Example

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.

Classification and Definitions

Example

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.

Classification and Definitions

Example

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?

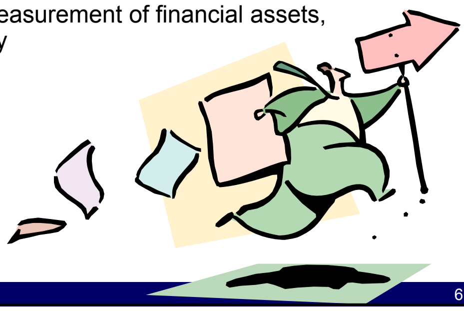
No.

- 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.

Today's Agenda

Measurement

- Subsequent measurement of financial assets, financial liability



Subsequent Measurement of F.A.

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

Subsequent Measurement of F.A.

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

Loans and receivables

HTM investments

Subsequent Measurement of F.A.

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

Loans and receivables

HTM investments

Subsequent Measurement of F.A.

Example

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

Subsequent Measurement of F.A.

Example

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

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

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

Subsequent Measurement of F.A.

Example

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

Subsequent Measurement of F.A.

Example

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

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

Subsequent Measurement of F.A.

Example

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

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

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

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

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

Subsequent Measurement of F.A.

Example

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

To recognise the interest income using the effective interest rate.

Dr	Cash	$475	
Cr	Loans and receivables		$475

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

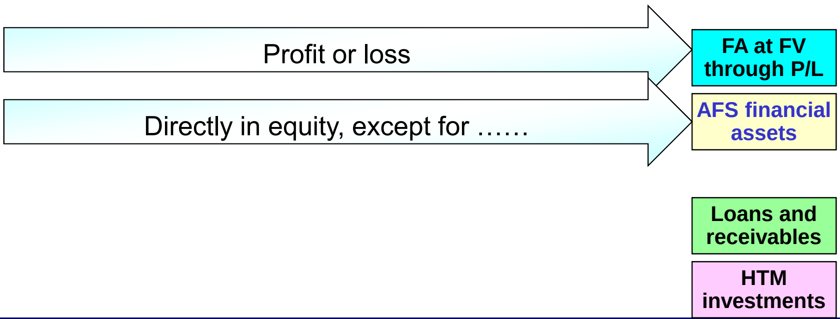
- The last two journal entries above may be combined and recognised as follows:

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

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

Subsequent Measurement of F.A.

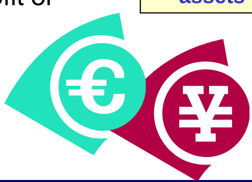
- The classification of financial assets determines
  - not only the measurement of financial assets
  - but also the recognition of changes in fair value of the financial assets and the gain or loss arising from such changes.



Subsequent Measurement of F.A.

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

AFS financial assets

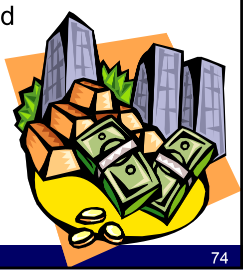


Impairment & Uncollectibility of F.A.

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

Impairment & Uncollectibility of F.A.

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



Impairment & Uncollectibility of F.A.

Investments in Equity Instruments without Fair Value

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

Impairment & Uncollectibility of F.A.

Loans and receivables & held-to-maturity investments

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

Impairment & Uncollectibility of F.A.

Loans and receivables & held-to-maturity investments

- **Two-Stage Assessment of Objective Evidence**
  - Before an impairment loss is measured and recognised, an entity is required to assess whether objective evidence of impairment exists for loans and receivables and held-to-maturity investments using a two-stage assessment approach as follows:
    1. First stage (individual assessment) – an entity is required to firstly assesses whether objective evidence of impairment exists
       - individually for the financial assets that are individually significant, and
       - individually or collectively for the financial assets that are not individually significant.
    2. Second stage (collective assessment) – If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment.

Impairment & Uncollectibility of F.A.

Case

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

- Accounting report 2006

  Impairment of financial assets

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

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

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

Impairment & Uncollectibility of F.A.

Loans and receivables & held-to-maturity investments

- If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the impairment loss is measured as the difference between
  - the asset's carrying amount and
  - the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition).

Impairment & Uncollectibility of F.A.

Loans and receivables & held-to-maturity investments

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

Impairment & Uncollectibility of F.A.

Example

Amortised Cost on Low Interest Loan

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

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

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

Impairment & Uncollectibility of F.A.

Example

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

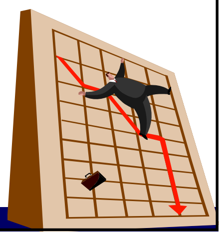
Carrying amount (per the balance as at 31.12.2006)	$ 48,167
Present Value of estimated future cash flows discounted at original effective interest rate as at 2.1.2006	44,500
Impairment loss	$ 3,667

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

Impairment & Uncollectibility of F.A.

Loans and receivables & held-to-maturity investments

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



Impairment & Uncollectibility of F.A.

Available-for-Sale Financial Assets

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

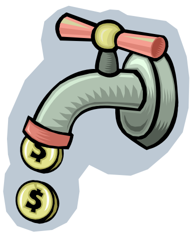
Impairment & Uncollectibility of F.A.

Available-for-Sale Financial Assets

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

Impairment & Uncollectibility of F.A.

Available-for-Sale Financial Assets



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

Impairment & Uncollectibility of F.A.

Example

Impairment at Initial Recognition

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

No.

- 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.

Impairment & Uncollectibility of F.A.

Example

Impairment Based on Ageing Analysis

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

Not necessarily.

- 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.

Impairment & Uncollectibility of F.A.

Example

Impairment on Portfolio Basis

- If one loan in Entity A is impaired but the fair value of another loan in Entity A is above its amortised cost.
- Does 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.

Impairment & Uncollectibility of F.A.

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?

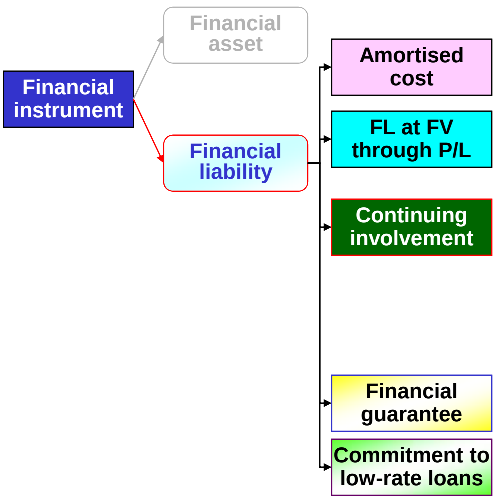
Not necessarily.

- 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).

Today's Agenda

Financial Liabilities

Classification of Financial Liability



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.

Classification of Financial Liability

Case

中保國際控股有限公司 China Insurance International Holdings Company Limited

- Accounting report 2006

Insurance creditors, accrued charges and other creditors and amounts due to group companies

- Insurance creditors, accrued charges and other creditors and amounts due to group companies are
  - o initially recognised at fair value and
  - o thereafter stated at amortised cost,
    - unless the effect of discounting would be immaterial, in which case they are stated at cost.

Classification of Financial Liability

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

Classification of Financial Liability

FL at FV through P/L

- Financial liabilities held for trading include:
  - a) derivative liabilities that are not accounted for as hedging instruments;
  - b) obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own);
  - c) financial liabilities that are incurred with an intention to repurchase them in the near term (e.g. a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
  - d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.
- The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

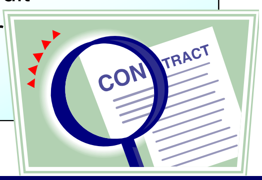
Classification of Financial Liability

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



Subsequent Measurement of F.L.

Financial guarantee

Commitment to low-rate loans

- Financial guarantee contracts and commitment to provide a loan at a below-market interest rate
  – are within the scope of 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.

Subsequent Measurement of F.L.

Financial guarantee

Commitment to low-rate loans

After initial recognition,

- An issuer of such contract and such guarantee shall measure it at the higher of:
  i) the amount determined in accordance with 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*.

Subsequent Measurement of F.L.

Financial guarantee

Asserted Explicitly

Used Insurance Accounting

- However, for financial guarantee contracts alone, such contracts may be excluded from the scope of 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.

Subsequent Measurement of F.L.

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.

HKAS 32, HKAS 39 and HKFRS 7
(Part 1)

5 June 2009

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HKAS 32, HKAS 39 and HKFRS 7
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