HKAS 32, HKAS 39 and HKFRS 7
(Part 2)

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Today's Agenda

Derivatives	• Accounting for derivatives and embedded derivatives
Derecognition	• Derecognition is allowed if conditions are met
Hedging	• Type of hedge and hedge accounting
Presentation (HKAS 32)	• Presentation of financial instruments, incl. to separate financial liabilities from equity
Disclosure (HKFRS 7)	• Disclosure of the significance and nature of risks arising from financial instruments

Today's Agenda

Derivatives

- Accounting for derivatives and embedded derivatives

Derivative & Embedded Derivative

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

Value change based on an underlying

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

Little or no initial net investment

b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

Settled at a future date

c) it is settled at a future date.

Financial instrument → Financial asset / Financial liability or Equity instrument

Derivative

Derivative & Embedded Derivative

Example

Derivative

Typical example:

- Future and forward
- Swap and options

Value change based on an underlying

Little or no initial net investment

Settled at a future date

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

Derivative & Embedded Derivative

Derivative

- What is the initial measurement and subsequent measurement on derivative?

Initial measurement

- Similar to other financial assets and liabilities
  - Fair value plus transaction cost, except for those classified at fair value through profit or loss
- But, a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument) is classified as fair value through profit or loss
  - Implies fair value only

Subsequent measurement

- As above, derivative, other than a financial guarantee contract or a designated and effective hedging instrument, is
  - classified and measured at fair value through profit or loss

Derivative & Embedded Derivative

Case

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

- Accounting report 2006

  Derivative financial instruments

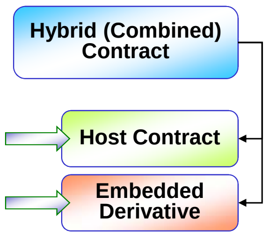
  - Derivative financial instruments include
    - options embedded in convertible bonds purchased by the Group,
    - derivatives embedded in certain insurance contracts,
    - interest rate swaps and futures,
    - credit default swaps,
    - cross currency swaps,
    - forward currency contracts, and
    - options on interest rates, currencies and equities, etc.
  - Derivative financial instruments are classified as held for trading
    - unless they are designated as effective hedging instruments.
  - All derivatives are carried
    - as assets when the fair values are positive and
    - as liabilities when the fair values are negative.

Dr Asset
Cr Cash

Dr Cash
Cr Liabilities

Derivative & Embedded Derivative

- A holder of a hybrid (combined) instrument is required to evaluate whether the embedded derivative should be separately accounted for in accordance with HKAS 39.
- A hybrid instrument includes
  - a non-derivative host contract and
  - an embedded derivative with the effect that some of the cash flows of the hybrid instrument vary in a way similar to a stand-alone derivative.
- However, a derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

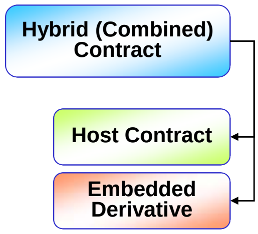


Sourced from *Intermediate Financial Reporting (2008)* by Nelson Lam and Peter Lau

Derivative & Embedded Derivative

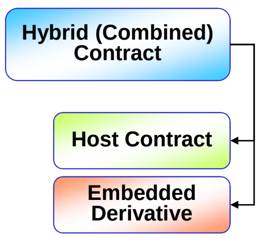
Example

- Examples of contract with embedded derivative include:
  1. A call, put, or prepayment option embedded in a host debt contract.
  2. An option or automatic provision to extend the remaining term to maturity of a debt instrument.
  3. Equity-indexed interest or principal payments embedded in a host debt instrument.
  4. Commodity-indexed interest or principal payments embedded in a host debt instrument.
  5. An equity conversion feature embedded in a convertible debt instrument.

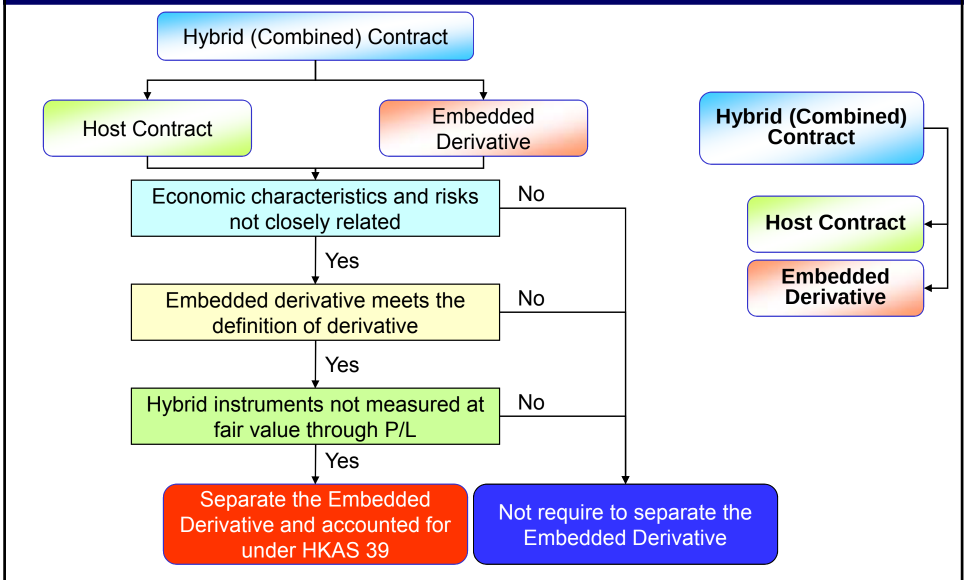


Derivative & Embedded Derivative

- HKAS 39 requires an entity to separate an embedded derivative from the host contract and account for such embedded derivative as a derivative if, and only if:
  1. the <u>economic characteristics and risks</u> of the embedded derivative are <u>not closely related</u> to the economic characteristics and risks of the host contract;
  2. a separate instrument with the same terms as the embedded derivative would <u>meet the definition of a derivative</u>; and
  3. the hybrid instrument is <u>not measured at fair value with changes in fair value recognised in profit or loss</u> (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

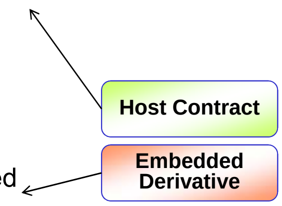


Derivative & Embedded Derivative



Derivative & Embedded Derivative

- If an embedded derivative is separated, the host contract is accounted for
  - under HKAS 39 if it is a financial instrument, and
  - in accordance with other appropriate accounting standards if it is not a financial instrument.
- HKAS 39 does not address whether an embedded derivative is presented separately on the face of the financial statements.
- The separated embedded derivative is similar to a simple derivative to be accounted for in the same manner as other derivatives.



Derivative & Embedded Derivative

- If a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:
  1. the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or
  2. it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

Hybrid (Combined) Contract

Derivative & Embedded Derivative

- If an entity is required by HKAS 39 to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately (either at acquisition or subsequently),
  - the entity is required to designate the entire hybrid contract as at fair value through profit or loss.

Hybrid (Combined) Contract

Derivative & Embedded Derivative

Example

Capital protection bond, guarantee fund or bond with index-linked interest

Can a bond with a fixed payment at maturity and a fixed maturity date be classified as a held-to-maturity investment if the bond's interest payments are indexed to the price of a commodity or equity, and the entity has the positive intention and ability to hold the bond to maturity?

Yes, but ……

- 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 (HKAS 39.11).
- HKAS 39.12 (stated at fair value through profit or loss) is not applicable
  - since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

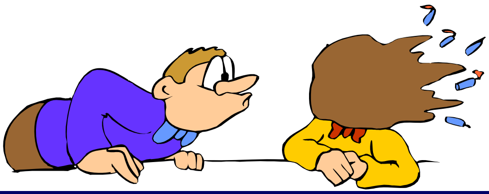
Today's Agenda

Derecognition

- Derecognition is allowed if conditions are met

Derecognition of Financial Asset

- Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.
  - Derecognition of an asset or a liability is originally a simple concept.
- Practically, it is not that simple for financial assets and financial liabilities.
  - Even a financial asset or a financial liability had been transferred, either or both the risk and reward and control of the financial asset or the obligation of the financial liability might have not been transferred.
  - HKAS 39 sets out detailed derecognition criteria and requirements on financial assets and financial liabilities separately.



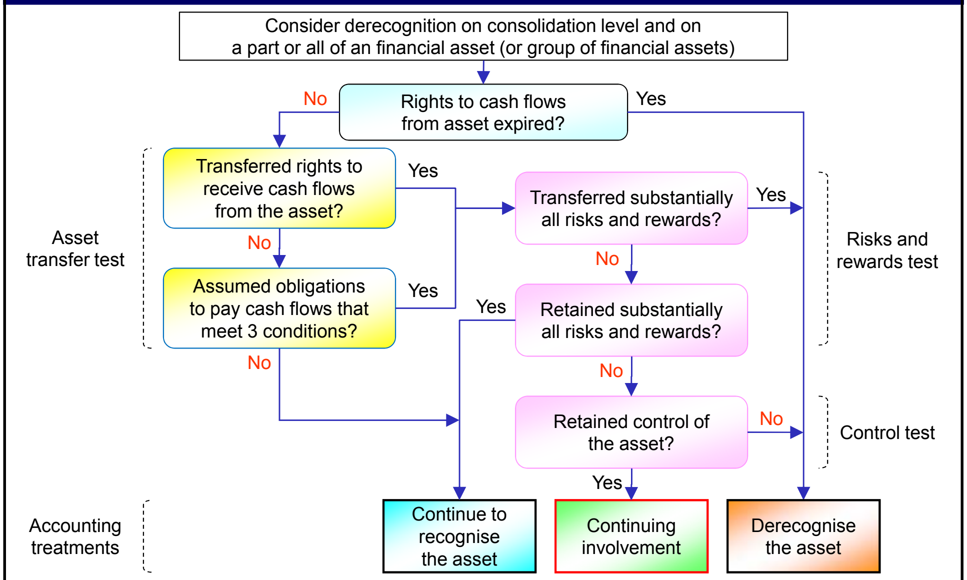
Derecognition of Financial Asset

- The general derecognition criteria in accordance with HKAS 39 require an entity to derecognise a financial asset when, and only when:
  1. the contractual rights to the cash flows from the financial asset expire; or
  2. the entity transfers the financial asset that meet the conditions set out in HKAS 39 (i.e. "**asset transfer test**") and

     the transfer qualifies for derecognition in accordance with HKAS 39

     (i.e. the "**risks and rewards test**", and the "**control test**")

Derecognition of Financial Asset



Derecognition of Financial Asset

Example

a) an unconditional sale of a financial asset;
b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
c) a sale of a financial asset together with a put or call option that is deeply out of the money (i.e. an option that is so far out of the money it is highly unlikely to go into the money before expiry).

Transferred substantially all risks and rewards?

Retained substantially all risks and rewards?

a) a sale & repurchase transaction where the repurchase price is a fixed price or a sale price plus a lender's return;
b) a securities lending agreement
c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity
d) a sale of a financial asset together with a deep in-the-money put/call option
e) a sale of short-term receivables in which the entity guarantees to compensate the buyer for any credit losses

Derecognition of Financial Asset

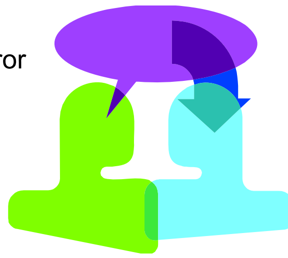
- By applying the risks and rewards test together with the control test on a derecognition transaction:

Findings of risks & rewards test and control test	Corresponding accounting treatments
1. Transfers substantially all the risks and rewards of ownership	Transfer qualified for derecognition • To derecognise the financial asset • To recognise separately as assets/liabilities any rights & obligations created/retained in the transfer
2. Retains substantially all the risks and rewards of ownership	Transfer not qualified for derecognition • To continue to recognise the financial asset
3. Neither transfers nor retains substantially all the risks and rewards of ownership and not retained control	Transfer qualified for derecognition • To derecognise the financial asset • To recognise separately as assets/liabilities any rights & obligations created/retained in the transfer
4. Neither transfers nor retains substantially all the risks and rewards of ownership but retained control	Continuing involvement • To continuously recognise the financial asset to the extent of its continuing involvement in the asset • To recognise an associate liability

Derecognition of Financial Asset

Requirements for All Transfers

- If a transferred asset continues to be recognised,
  - the asset and the associated liability cannot be offset.
- Similarly, the entity is not allowed to offset any income arising from the transferred asset with any expense incurred on the associated liability.
- If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee,
  - the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted.



Derecognition of Financial Liability

- An entity is required to remove a financial liability (or a part of a financial liability) from its balance sheet (i.e. derecognise a financial liability) when, and only when, it is extinguished.
  - HKAS 39 explains that a financial liability is extinguished
    - when the obligation specified in the contract is discharged or cancelled or expires.
- A financial liability or part of it is extinguished when the debtor either:
  1. discharges the liability or part of it by paying the creditor, normally with cash, other financial assets, goods or services; or
  2. is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor.

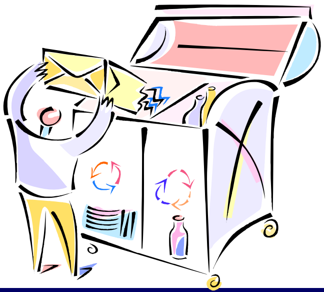
Derecognition of Financial Liability

- When there is an exchange between an existing borrower and lender of debt instruments with substantially different terms or a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor),
  - such an exchange of debt instruments or substantial modification of terms is accounted for as:
    - an extinguishment of the original financial liability and
    - the recognition of a new financial liability.

Derecognition of Financial Liability

- The recognition of a new financial liability
  - implies that the new liability is measured at fair value plus transaction costs at the date of extinguishment.
- The difference between
  - the carrying amount of a financial liability (or part of it) extinguished or transferred to another party and
  - the consideration paid, including any non-cash assets transferred or liabilities assumed,

  is recognised in profit or loss.



Today's Agenda

Hedging

- Type of hedge and hedge accounting

Hedging – Introduction

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

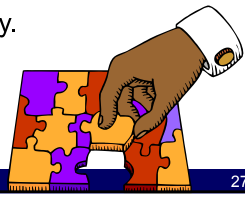
A Hedge under HKAS 39 involves 2 components

Hedging Instrument | **Hedged Item**

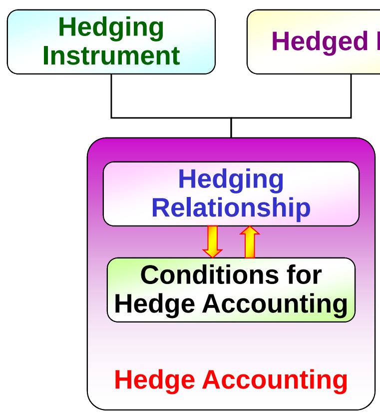
HKAS 39 sets out **Hedge Accounting** which recognises the offsetting effects on profit or loss of changes in the fair values of these 2 components.

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

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



Hedging – Introduction

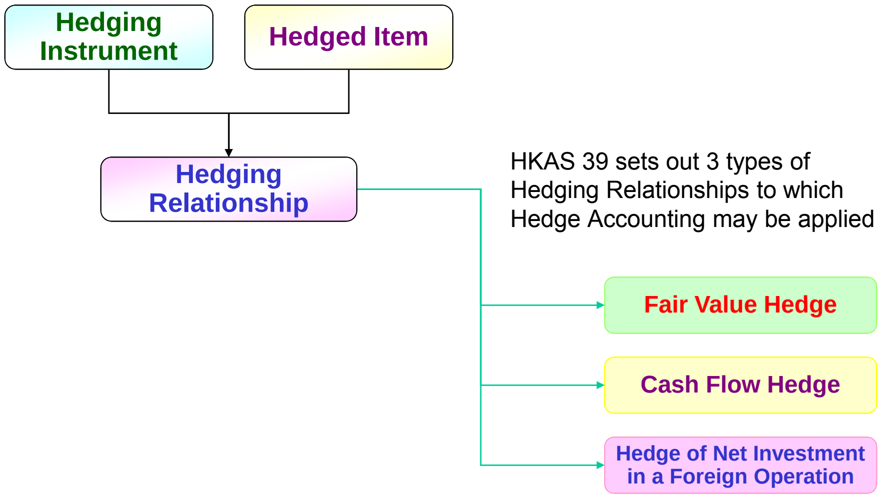


HKAS 39

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

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

Hedging – Hedge Relationship



Hedging – Hedge Relationship

Fair Value Hedge

A hedge of the <u>exposure to changes in fair value</u> of

- a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such items

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

Cash Flow Hedge

A hedge of the <u>exposure to variability in cash flows</u> that

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

ii) could affect profit or loss

A hedge of the foreign currency risk of a firm commitment may be accounted for

- as a fair value hedge or as a cash flow hedge

Hedge of Net Investment in a Foreign Operation

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

Hedging – Hedge Relationship

Example

Fair Value Hedge

Cash Flow Hedge

Hedge of Net Investment in a Foreign Operation

Determine the classification for the following hedge:

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

Hedging – Hedge Accounting Conditions

Hedging Instrument | **Hedged Item**

↓

Hedging Relationship

⇕

Conditions for Hedge Accounting

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

Hedging – Hedge Accounting Conditions

All 5 Conditions for Hedge Accounting must be met:

- Formal documentation at inception
- Highly effective and consistent with originally documented risk
- Forecasted transaction to be highly probable (for cash flow hedge)
- Hedge effectiveness can be reliably measured
- Ongoing-assessed and actually highly effective

Conditions for Hedge Accounting

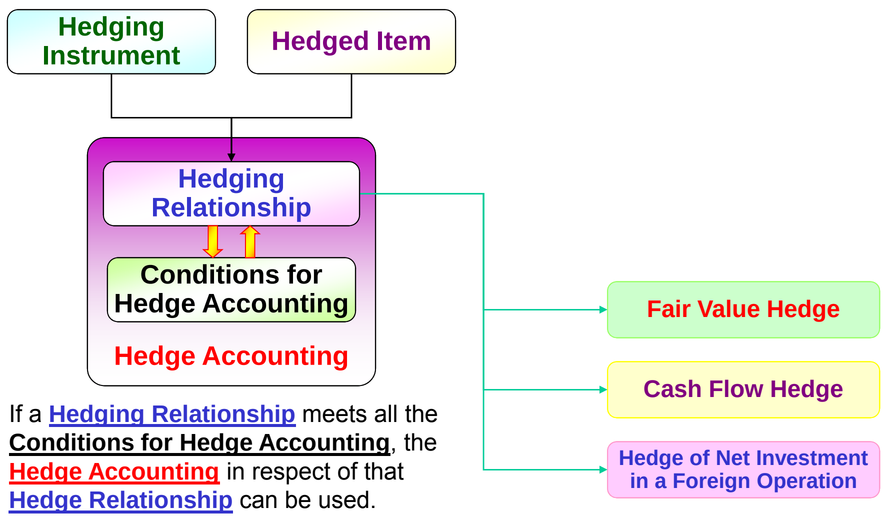
Hedging – Hedge Accounting Conditions

Formal documentation at inception

- At the inception of the hedge, there is formal designation and documentation of:
  - the hedging relationship and
  - the entity's risk management objective and strategy for undertaking the hedge.
- That documentation shall include:
  - identification of the hedging instrument,
  - the hedged item or transaction,
  - the nature of the risk being hedged and
  - how the entity will assess
    - the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

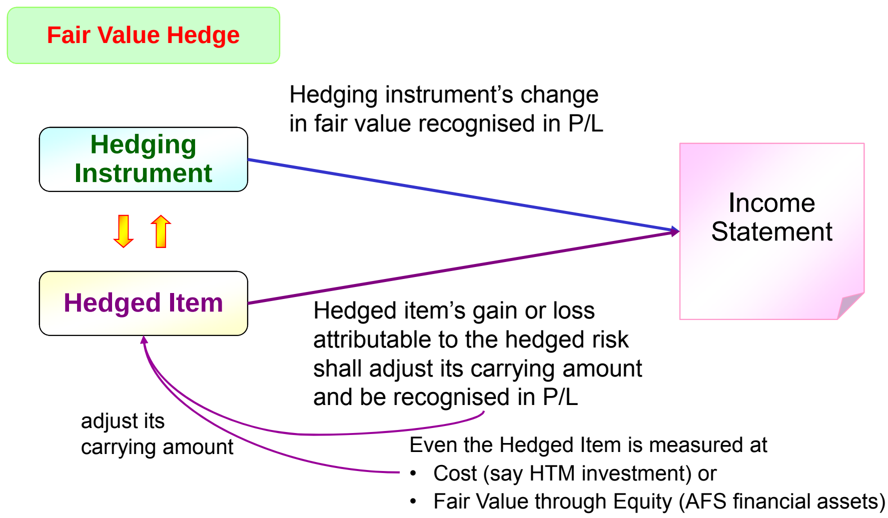
Hedge Effectiveness

Hedging – Hedge Accounting



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

Hedging – Hedge Accounting



Hedging – Hedge Accounting

Example

Interest Rate Swap on A Fixed Rate Financial Asset

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

Hedging – Hedge Accounting

Example

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

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

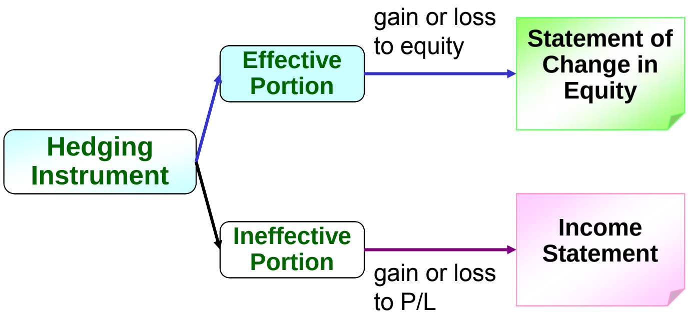
- While the swap is a derivative, it is measured at fair value with changes in fair value recognised in profit or loss.

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

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

Hedging – Hedge Accounting

Cash Flow Hedge



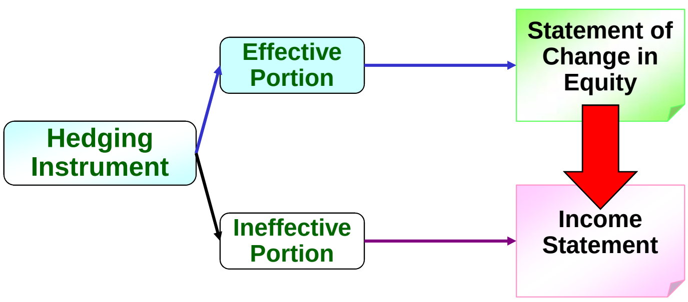
How's the treatment, if it is …..

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

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

Hedging – Hedge Accounting

Cash Flow Hedge



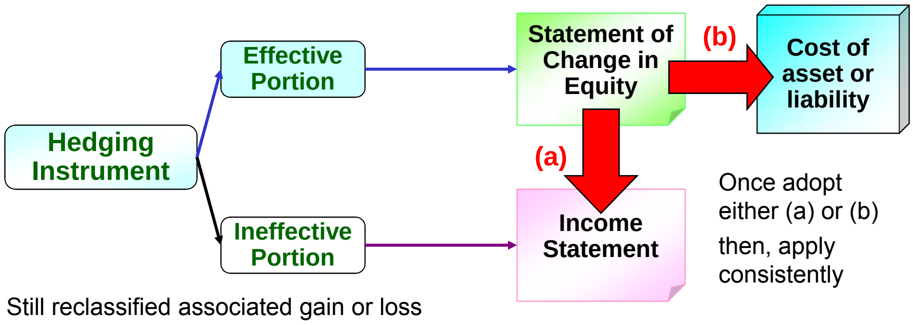
Hedge of a forecast transaction resulting in recognition of **Financial Asset or Financial Liability**

Reclassified associated gain or loss recognised in equity to P/L in case of

- Final recognition of financial assets or financial liabilities, or
- Loss recognised directly in equity is expected not to be recovered

Hedging – Hedge Accounting

Cash Flow Hedge



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

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

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

Associated gain or loss will also be either

a) reclassified to P/L, or

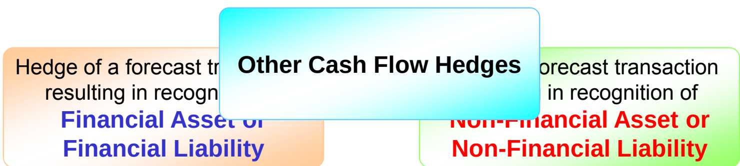
b) included in cost of assets or liabilities

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

Hedging – Hedge Accounting

Cash Flow Hedge

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



Hedging – Hedge Accounting

Example

Hedge of Forecast Transaction

- Entity A trades in UK mainly in UK Sterling.
  - It expects to purchase a machine for 1 million Euros in one year from 1 May 2006.
  - In order to offset the risk of increases in the Euro rate, Entity A enters into a forward contract to purchase 1 million Euros in 1 year for a fixed amount (£650,000).
  - The forward contract is designated as a Cash Flow Hedge.
  - At inception, the forward contract has a fair value of zero.

- At the year-end of 31 October 2006
  - the Euro has appreciated and the value of 1 million Euros is £660,000.
  - The fair value of the forward contract rises to £10,000.
  - The machine will still cost 1 million Euros so the company concludes that the hedge is 100% effective.

Hedging – Hedge Accounting

Example

- The entire change in the fair value of the hedging instrument is recognised directly in reserves.

Dr Forward contract	£10,000	
Cr Reserves		£10,000

How to treat this amount finally?

- The forward contract is settled with no further change in the exchange rate:

Dr Cash	£10,000	
Cr Forward contract		£10,000

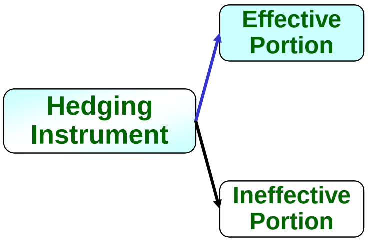
- The company purchases the machine for 1 million euros and makes the following journal entry:

Dr Machine	£660,000	
Cr Accounts Payable		£660,000

- The gain of £10,000 recognised in reserve (equity) should either
  - be reclassified from equity into P/L, or
  - be reclassified from equity and included in the initial carrying amount of the machine (for non-financial assets or liabilities only)
  - once this policy is chosen, it must be used consistently

Hedging – Hedge Accounting

Hedge of Net Investment in a Foreign Operation



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

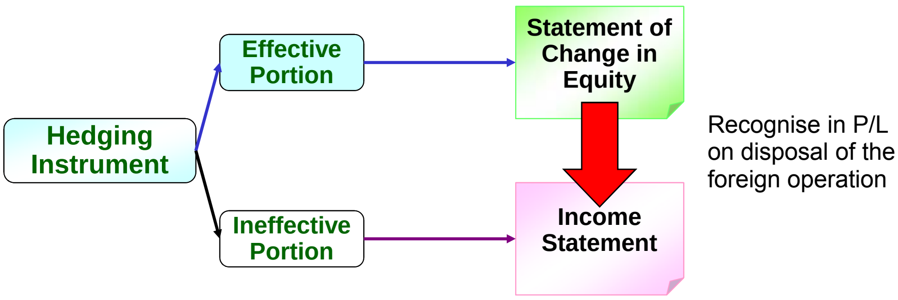
a) the portion of the gain or loss on the **Hedging Instrument** that is determined to be an **effective hedge** shall be **<u>recognised directly in equity</u>** through the statement of changes in equity; and

b) the **ineffective portion** shall be **<u>recognised in profit or loss</u>**.

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

Hedging – Hedge Accounting

Hedge of Net Investment in a Foreign Operation



Hedge – Cease Hedge Accounting

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

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

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

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

Today's Agenda

Presentation (HKAS 32)

- Presentation of financial instruments, incl. to separate financial liabilities from equity

HKAS 32 – Presentation

Presentation from the perspective of the issuer on

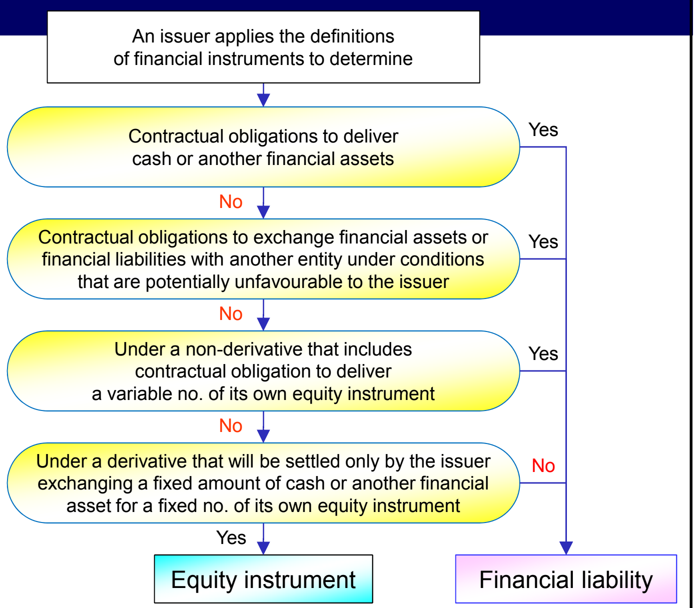
- **Liability and equity**
- **Compound financial instruments**
- **Treasury shares**
- **Interests, dividends, losses and gains**
- **Offsetting**

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

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

HKAS 32 – Presentation

Liability and equity



HKAS 32 – Presentation

Presentation from the perspective of the issuer on

Compound financial instruments

Compound financial instrument is an instrument containing both a liability and an equity component

- HKAS 32
  - applies only to issuers of non-derivative compound financial instruments and
  - does not deal with compound financial instruments from the perspective of holders.
- HKAS 39
  - deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain debt and equity features.

 51

HKAS 32 – Presentation

Presentation from the perspective of the issuer on

Compound financial instruments

Evaluation and Initial Classification

- The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instruments
  – to determine whether it contains both a liability and an equity component.
- Such components shall be classified separately as financial liabilities, financial assets or equity instrument in accordance with
  – the substance of the contractual arrangement and
  – the definitions of a financial liability, financial asset and an equity instrument.
- An entity recognises separately the components of a financial instrument that
  a) creates a financial liability of the entity, and
  b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity.

 52

HKAS 32 – Presentation

Example

Presentation from the perspective of the issuer on

Compound financial instruments

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

5% Convertible Bond

= 5% 5-year Bond + an Option (to convert shares)

5% 5-year Bond → Liability

an Option (to convert shares) → **Equity**

- To find out the equity component:

5% Convertible Bond – 5% 5-Yr Bond = Option

5% Convertible Bond: Cash received

5% 5-Yr Bond: Use DCF method (liability component)

Option: **Residual**

- **To classify as Equity**

HKAS 32 – Presentation

Presentation from the perspective of the issuer on

Treasury shares

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

HKAS 32 – Presentation

Presentation from the perspective of the issuer on

Interests, dividends, losses and gains

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

HKAS 32 – Presentation

Case

Standard Chartered

Annual report of 2005 sets out that:

- Preference shares, which
  - carry a mandatory coupon,
  - or are redeemable on a specific date
  - or at the option of the shareholder,

  are classified as financial liabilities and are presented in other borrowed funds.
- The dividends on these preference shares
  - are recognised in the income statement as interest expense on an amortised cost basis using the effective interest method.

HKAS 32 – Presentation

Presentation from the perspective of the issuer on

Offsetting

- Financial asset and a financial liability are offset and the net amount presented in the balance sheet when, and only when, an entity:
  1. currently has a legally enforceable right to set off the recognised amounts; and
  2. intends either
     - to settle on a net basis, or
     - to realise the asset and settle the liability simultaneously.
- In accounting for a transfer of a financial asset that does not qualify for derecognition,
  – the entity is not allowed to offset the transferred asset and the associated liability

Today's Agenda

Disclosure (HKFRS 7)

- Disclosure of the significance and nature of risks arising from financial instruments

HKFRS 7 – Introduction

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

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

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

     how the entity manages those risks.

Significance

- Balance sheet
- Income statement
- Other disclosures

Nature and Extent

- Qualitative disclosures
- Quantitative disclosures

1. Significance of Financial Instruments

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

Significance

- Balance Sheet
- Income Statement and Equity
- Other Disclosures

1. Significance of Financial Instruments

Balance Sheet

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

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

1. Significance of Financial Instruments

Case

ZiJin
紫金礦業集團股份有限公司
ZIJIN MINING GROUP COMPANY LIMITED*

	Financial assets at fair value through profit or loss – held for trading RMB'000	Loans and receivables RMB'000	Available-for-sale financial assets RMB'000	Total RMB'000
Financial assets included in other assets (note 18)	–	80,000	–	80,000
Interests in associates (notes 22)	–	10,000	–	10,000
Interests in jointly-controlled entities (note 23)	–	19,128	–	19,128
Available-for-sale investments	–	–	462,178	462,178
Financial assets included in prepayments, deposits and other receivables	–	321,664	–	321,664
Trade receivables	–	293,870	–	293,870
Bills receivables	–	52,346	–	52,346
Equity investments at fair value through profit or loss	102,439	–	–	102,439
Derivative financial instruments	4,440	–	–	4,440
Pledged deposits	–	52,088	–	52,088
Cash and cash equivalents	–	2,184,510	–	2,184,510
	106,879	3,013,606	462,178	3,582,663

1. Significance of Financial Instruments

- In March 2009, HKFRS 7 was amended to require the disclosure of the fair value hierarchy, which shall have the following levels:
  a. quoted prices (unadjusted) in active markets for identical assets or liabilities (**Level 1**);
  b. inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices) (**Level 2**); and
  c. inputs for the asset or liability that are not based on observable market data (unobservable inputs) (**Level 3**).

1. Significance of Financial Instruments

Case

HSBC

	Valuation Techniques			
At 31 December 2008 (US$m)	Quoted market price	Using observable inputs	With significant unobservable inputs	Total
Assets				
Trading assets	234,399	185,369	7,561	427,329
Financial assets designated at FV	14,590	13,483	460	28,533
Derivatives	8,495	476,498	9,883	494,876
Financial instruments: AFS	103,949	173,157	9,116	286,222
Liabilities				
Trading liabilities	105,584	135,559	6,509	247,652
Financial liabilities designated at FV	23,311	51,276	-	74,587
Derivatives	9,896	473,359	3,805	487,060

2. Nature and Extent of Risks

Significance

↓

Nature and Extent

2. Nature and Extent of Risks

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

Nature and Extent

- Qualitative Disclosures
- Quantitative Disclosures

2. Nature and Extent of Risks

- The disclosures required focus on
  - the risks that arise from financial instruments and
  - how they have been managed.
- These risks typically include, but are not limited to, credit risk, liquidity risk and market risk.
- It implies that the disclosures requirements are required
  - not only on credit risk, liquidity risk and market risk
  - but also on other risks that may be identified by the entity for its financial instruments.

Qualitative Disclosures

Quantitative Disclosures

2. Nature and Extent of Risks

- The disclosures in respect of the nature and extent of risks arising from financial instruments can be either
  1. given in the financial statements or
  2. incorporated by cross-reference from the financial statements to some other statement, that is available to users of the financial statements
     - on the same terms as the financial statements and
     - at the same time.

  Without the information incorporated by cross-reference, the financial statements are incomplete. (HKFRS 7.BC46)

e.g. risk report, or management commentary

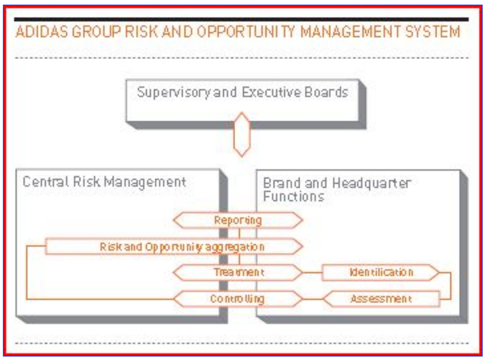
Qualitative Disclosures

Quantitative Disclosures

2. Nature and Extent of Risks

Example

- Adidas's 13-page
  - "Risk and Opportunity Report"
- HSBC's 97-page
  - "The Management of Risk" incorporated in the Report of Directors



e.g. risk report, or management commentary

Qualitative Disclosures

Quantitative Disclosures

2. Nature and Extent of Risks

Qualitative Disclosures

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

2. Nature and Extent of Risks

Quantitative Disclosures

- For each type of risk arising from financial instruments, an entity shall disclose:
  a. Summary quantitative data about its exposure to that risk at the reporting date.
     - The level of detail of such disclosure is based on the information provided internally to key management personnel of the entity (as defined in HKAS 24 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.
  b. the disclosures required in quantitative disclosures, to the extent not provided in (a), unless the risk is not material (see HKAS 1.29-31).
  c. concentrations of risk if not apparent from (a) and (b)

2. Nature and Extent of Risks

Example

- Can an entity avoid disclosure of nature and extent of risk by
  – Unwinding a position of large exposure in a particular currency, or
  – Disposal of its large portfolio in equity instruments ?

- If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, an entity is still required to provide further information that is representative.
- When an entity typically has a large exposure to a particular currency or an equity investments, but at year-end unwinds the position,
  – the entity might disclose a graph that shows the exposure at various times during the period, or disclose the highest, lowest and average exposures during the period. (HKFRS 7.IG20)

2. Nature and Extent – Credit Risk

Quantitative Disclosures

Credit risk

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

2. Nature and Extent – Past Due

Quantitative Disclosures

Financial assets that are either past due or impaired

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

2. Nature and Extent – Past Due

Case

Early adopted HKFRS 7 in 2005 and its annual report 2006 states that (extract only):

香港交易所 HKEx

(iv) Financial assets that were past due but not impaired

As at 31 December, the age analysis of the trade receivables of the Group that were past due but not determined to be impaired according to the period past due was as follows:

	Group	
	2006 $'000	2005 $'000
Up to 6 months	186,359	141,277
Over 6 months to 1 year	–	–
Over 1 year to 3 years *	–	8,521
Over 3 years *	8,651	142
Total	195,010	149,940

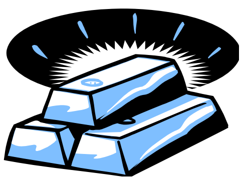
* No provision for impairment losses has been made against trade receivables amounting to $8,510,000 (2005: $8,521,000) as the balances can be recovered from the Clearing House Funds.

2. Nature and Extent – Collateral

Quantitative Disclosures

Collateral and other credit enhancements obtained

- When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (eg guarantees), and such assets meet the recognition criteria in other Standards, an entity shall disclose:
  - a) the nature and carrying amount of the assets obtained; and
  - b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.



2. Nature and Extent – Liquidity Risk

Quantitative Disclosures

Liquidity risk

- Before HKFRS 7, contractual maturity analysis together with effective interest rate analysis was required by HKAS 32 for interest rate risk disclosure.
- HKFRS 7 now requires, for liquidity risk disclosure, an entity to disclose:
  - a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and
  - b) a description of how it manages the liquidity risk inherent in (a).

2. Nature and Extent – Liquidity Risk

Case

Early adopted HKFRS 7 in 2005 and its annual report 2006 states that (extract only):

香港交易所 HKEx

– The financial liabilities of the Group and HKEx as at 31 Dec. 2006 are analysed into relevant maturity buckets based on their contractual maturity dates in the table below:

	Group 2006					
	Up to 1 month $'000	>1 month to 3 months $'000	>3 months to 1 year $'000	>1 year to 5 years $'000	Not determinable $'000	Total $'000
Current liabilities						
Margin deposits from Clearing Participants on derivatives contracts	21,666,474	-	-	-	-	21,666,474
Accounts payable, accruals and other liabilities	11,042,527	45,937	234	363	18,139	11,107,200
Participants' admission fees received	700	50	600	-	350	1,700
	32,709,701	45,987	834	363	18,489	32,775,374

2. Nature and Extent – Market Risk

Quantitative Disclosures

Market risk

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

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

2. Nature and Extent – Market Risk

Quantitative Disclosures

Market risk

- is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices
- comprises three types of risk:
  – currency risk,
  – interest rate risk and
  – other price risk.

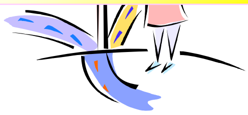
2. Nature and Extent – Sensitivity

Quantitative Disclosures

Market risk – **Simple sensitivity analysis**

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

Assuming that a **reasonably possible change** in the relevant risk variable had occurred at the balance sheet date and had been applied to the risk exposures in existence at that date.



2. Nature and Extent – Sensitivity

In order to disclose the simple sensitivity analysis, an entity should:

1. Decide how much detail it provides, how much emphasis it places and how it aggregates information to display

↓

2. Identify each type of market risk to which the entity is exposed and the relevant risk variable at the reporting date

↓

3. Judge the reasonably possible changes in the relevant risk variables at the reporting date

↓

4. Calculate and show how profit or loss and equity would be affected at the reporting date

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

2. Nature and Extent – Sensitivity

In order to disclose the simple sensitivity analysis, an entity should:

1. Decide how much detail it provides, how much emphasis it places and how it aggregates information to display

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

2. Nature and Extent – Sensitivity

Quantitative Disclosures

Market risk – Simple sensitivity analysis

- For each type of market risk, an entity decides:
  - how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments.
- For example, an entity that trades financial instruments might disclose
  - Sensitivity analysis for each type of market risk separately for
    - financial instruments held for trading and
    - those not held for trading.
- If an entity has exposure to only one type of market risk in only one economic environment,
  - it would not show disaggregated information.

2. Nature and Extent – Sensitivity

In order to disclose the simple sensitivity analysis, an entity should:

1. Decide how much detail it provides, how much emphasis it places and how it aggregates information to display
2. Identify each type of market risk to which the entity is exposed and the relevant risk variable at the reporting date

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

2. Nature and Extent – Sensitivity

Market Risk

Interest Rate Risk

- Interest rate risk arises
  - on interest-bearing financial instruments recognised in the balance sheet (e.g. loans and receivables and debt instruments issued) and
  - on some financial instruments not recognised in the balance sheet (e.g. some loan commitments).

2. Nature and Extent – Sensitivity

Market Risk

Currency Risk

- **Currency risk (or foreign exchange risk)** arises on financial instruments that are denominated in a foreign currency, i.e. in a currency other than the functional currency in which they are measured.
  – For the purpose of HKFRS 7, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.
  – A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

2. Nature and Extent – Sensitivity

Market Risk

Other Price Risk

- **Other price risk** arises on financial instruments because of changes in, for example:
  – commodity prices or
  – equity prices.
- To comply with HKFRS 7, an entity might disclose the effect of a decrease in a specified variable, including:
  – stock market index,
  – commodity price, or
  – other risk variable.
- For example,
  – if an entity gives residual value guarantees that are financial instruments, the entity discloses an increase or decrease in the value of the assets to which the guarantee applies.

2. Nature and Extent – Sensitivity

Example

- Market Risk
  - Other Price Risk

- Examples of financial instruments that give rise to equity price risk are
  - a) a holding of equities in another entity and
  - b) an investment in a trust that in turn holds investments in equity instruments.
- Other examples include
  - – forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices.
    - The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.

2. Nature and Extent – Sensitivity

Example

- Market Risk
  - Interest Rate Risk
  - Currency Risk
  - Other Price Risk
    - Equity Price Risk
    - Commodity Price Risk
    - Prepayment Risk
    - Residual Value Risk

Risk variables that are relevant <u>to disclosing market risk</u>

- Yield curve of market interest rates
- Foreign exchange rates
- Prices of equity instruments
- Market prices of commodities

2. Nature and Extent – Sensitivity

In order to disclose the simple sensitivity analysis, an entity should:

1. Decide how much detail it provides, how much emphasis it places and how it aggregates information to display
2. Identify each type of market risk to which the entity is exposed and the relevant risk variable at the reporting date
3. Judge the reasonably possible changes in the relevant risk variables at the reporting date

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

2. Nature and Extent – Sensitivity

Quantitative Disclosures

Market risk – Simple sensitivity analysis

- In determining what a reasonably possible change in the relevant risk variable is, an entity should consider:
  a. the economic environments in which it operates.
  b. the time frame over which it is making the assessment.

- A reasonably possible change should not include remote or "worst case" scenarios or "stress tests".
- Moreover, if the rate of change in the underlying risk variable is stable, the entity need not alter the chosen reasonably possible change in the risk variable.
- The sensitivity analysis shall show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period.

2. Nature and Extent – Sensitivity

Case

How can it be reasonably possible change?

Observed assessments by certain companies:

Entity name	Currency	Interest rate	Other price
BASF	10% (drop only)	1%	10%
BP plc	VaR	VaR	10%
CLP Holdings Ltd.	1%	0.5%	15% (2006: 5%)
DBS Group	10%	0.25%	10%
Deutsche Telecom	10%	1%	N/M
France Telecom	10%	1%	N/M
Jardine Matheson Ltd.	10%	1%	25% (AFS)
Recruit	7 – 12%	N/M	N/M
Zijin Mining	10%	1%	N/M

2. Nature and Extent – Sensitivity

In order to disclose the simple sensitivity analysis, an entity should:

1. Decide how much detail it provides, how much emphasis it places and how it aggregates information to display
2. Identify each type of market risk to which the entity is exposed and the relevant risk variable at the reporting date
3. Judge the reasonably possible changes in the relevant risk variables at the reporting date
4. Calculate and show how profit or loss and equity would be affected at the reporting date

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

2. Nature and Extent – Sensitivity

- HKFRS 7 requires the sensitivity analysis to show the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable. For this purpose:
  1. Entities are not required to determine what the profit or loss for the period would have been if relevant risk variables had been different.
     - Instead, entities disclose the effect on profit or loss and equity at the balance sheet date assuming that a reasonably possible change in the relevant risk variable had occurred at the balance sheet date and had been applied to the risk exposures in existence at that date.
  2. Entities are not required to disclose the effect on profit or loss and equity for each change within a range of reasonably possible changes of the relevant risk variable.
     - Disclosure of the effects of the changes at the limits (i.e. the upper and lower limits) of the reasonably possible range would be sufficient.

2. Nature and Extent – Sensitivity

Example

Market Risk

- HKFRS 7 requires separate disclosure on
  - the sensitivity of profit or loss
    (that arises, for example, from instruments classified as at fair value through profit or loss and impairments of available-for-sale financial assets) is disclosed separately from
  - the sensitivity of equity
    (that arises, for example, from instruments classified as available for sale).
- Financial instruments that an entity classifies as equity instruments are not remeasured.
  - Neither profit or loss nor equity will be affected by the equity price risk of those instruments.
  - Accordingly, no sensitivity analysis is required.

2. Nature and Extent – Sensitivity

Example

Example of financial assets and liabilities

Risk variables that are relevant to disclosing market risk

- Investment in bonds, bank deposits, interest-bearing borrowings, bank loans

Yield curve of market interest rates

- For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on:
  a) interest income and expense;
  b) other line items of profit or loss (such as trading gains and losses); and
  c) when applicable, equity.
- An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk.

2. Nature and Extent – Sensitivity

Quantitative Disclosures

Market risk – Interdependency Sensitivity Analysis

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

2. Nature and Extent – Sensitivity

Quantitative Disclosures

Market risk – **Interdependency Sensitivity Analysis**

- An entity might comply the VaR methodology by disclosing
  - the type of VaR model used (eg whether the model relies on Monte Carlo simulations),
  - an explanation about how the model works and
  - the main assumptions (eg the holding period and confidence level).
- Entities might also disclose
  - the historical observation period and weightings applied to observations within that period,
  - an explanation of how options are dealt with in the calculations, and
  - which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

2. Nature and Extent – Sensitivity

Case

Royal Dutch Shell plc for 2007

- Shell uses risk management systems for recording and valuing instruments.
- There is regular review of mandated trading limits by senior management, daily monitoring of market risk exposure using value-at-risk (VAR) techniques (see below), daily monitoring of trading positions against limits and marking-to-market of trading exposures with a department independent of traders reviewing the market values applied to trading exposures.
- Shell's exposure to substantial trading losses is therefore considered limited.
- Shell utilises VAR techniques based on variance/covariance or Monte Carlo simulation models and make a statistical assessment of the market risk arising from possible future changes in market values over a 24-hour period and within a 95% confidence level.
- The calculation of the range of potential changes in fair value takes into account positions, the history of price movements and the correlation of these price movements.
- Each of the models is regularly back tested against actual fair value movements to ensure model integrity is maintained.

HKAS 32, HKAS 39 and HKFRS 7
(Part 2)

12 June 2009

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HKAS 32, HKAS 39 and HKFRS 7
(Part 2)

12 June 2009

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