Financial Instruments Standards
(Part 1)

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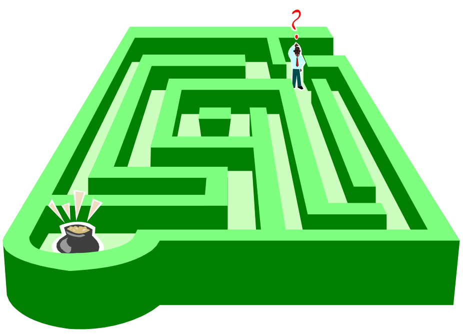
HKAS 32, HKAS 39, HKFRS 7 and HKFRS 9

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

Professor Sir David Tweedie
Chairman of IASB



Background

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

Background

- In response to the input received on its work responding to the financial crisis, and following the conclusions of the G20 leaders and the recommendations of international bodies,
  - the IASB announced an accelerated timetable for replacing IAS 39 in April 2009, and
  - finally, IFRS 9 *Financial Instruments* in Nov. 2009
- HKFRS 9 was issued to maintain international convergence with the issuance of IFRS 9.

Background

- It is intended that HKFRS 9 will ultimately replace HKAS 39 in its entirety.
  - However, in response to requests from interested parties that the accounting for financial instruments should be improved quickly, the project to replace HKAS 39 is divided into three main phases.
- As each phase is completed, as well as its separate project on the derecognition of financial instruments,
  - the relevant portions of HKAS 39 will be deleted and
  - chapters in HKFRS 9 will be created to replace the requirements in HKAS 39.
- The replacement of HKAS 39 in its entirety is aimed to be completed by the end of 2010.

Background

- HKFRS 9 issued so far includes only the chapters relating to the classification and measurement of financial assets.
  - HKFRS 9 addressed those matters first because they form the foundation of a standard on reporting financial instruments.
  - Moreover, many of the concerns expressed during the financial crisis arose from the classification and measurement requirements for financial assets in HKAS 39.

Financial Assets Only

Background

Structure of HKFRS 9 (in chapters)

1 Objective
2 Scope
3 Recognition and Derecognition
4 Classification
5 Measurement
6 Hedge Accounting *(not used yet)*
7 Disclosures *(not used yet)*
8 Effective Date and Transition

Background

HKAS 32

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

HKFRS 7

- Disclosure requirements

HKFRS 9

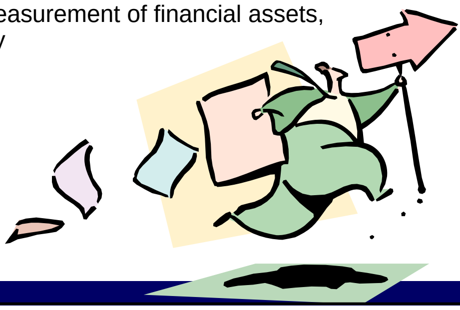
- Classification and measurement

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

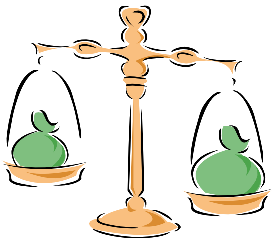
2. that were entered into and continue to be held
   - for the purpose of the receipt or delivery of a non-financial item
   - in accordance with the entity's expected purchase, sale or usage requirements

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 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.)*

Financial instrument

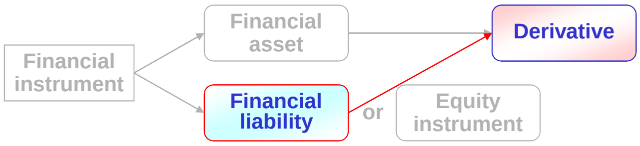
Financial asset → Derivative

Financial liability or Equity instrument

Scope – What is Financial Instrument?

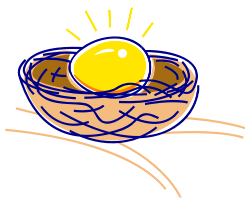
Financial liability is any liability that is

- 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



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

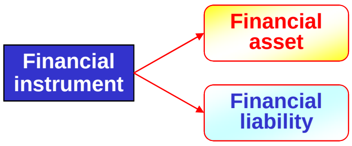
- All financial instruments, including derivatives, are recognised in the balance sheet (on balance sheet).

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



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 net settlement 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 applied consistently 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

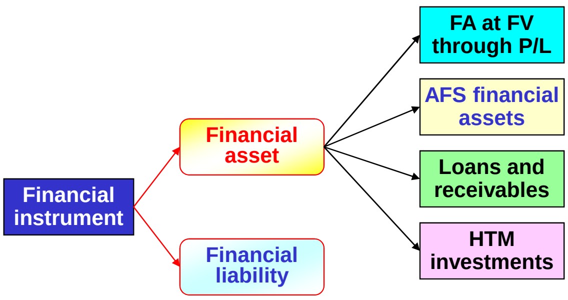
Today's Agenda

Classification

- Classification of financial assets, financial liability and equity

Classification under HKAS 39

Based on original HKAS 39



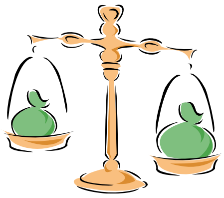
1. Financial assets at fair value through profit or loss
2. Available-for-sale financial assets
3. Loans and receivables
4. Held-to-maturity investments

- 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 under HK

Based on original HKAS 39



The categories named in HKAS 39

- 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

FA at FV through P/L

AFS financial assets

Loans and receivables

HTM investments

Classification under HK

Based on original HKAS 39

Determine the category of a financial asset for subsequent measurement

- Meet conditions as investments in equity instruments without fair value — yes → Investments in equity instruments without fair value (at cost); no ↓
- Classified as held for trading — yes → Financial assets at fair value through profit or loss; no ↓
- Designated as at fair value through profit or loss — yes → Financial assets at fair value through profit or loss; no ↓
- Designated as available for sale — yes → Available-for-sale financial assets (at fair value through equity); no ↓
- Meet the definition of loans and receivables — yes → Loans and receivables (at amortised cost); no ↓
- Meet the definition and tainting rule of held-to-maturity investments — yes → Held-to-maturity investments (at amortised cost); no → Available-for-sale financial assets (at fair value through equity)

FA at FV through P/L

AFS financial assets

Loans and receivables

HTM investments

Classification under HKFRS 9

- Unless para. 4.5 of HKFRS 9 (so-called “fair value option”) applies, an entity shall classify financial assets as subsequently measured at either
  - amortised cost or
  - fair value

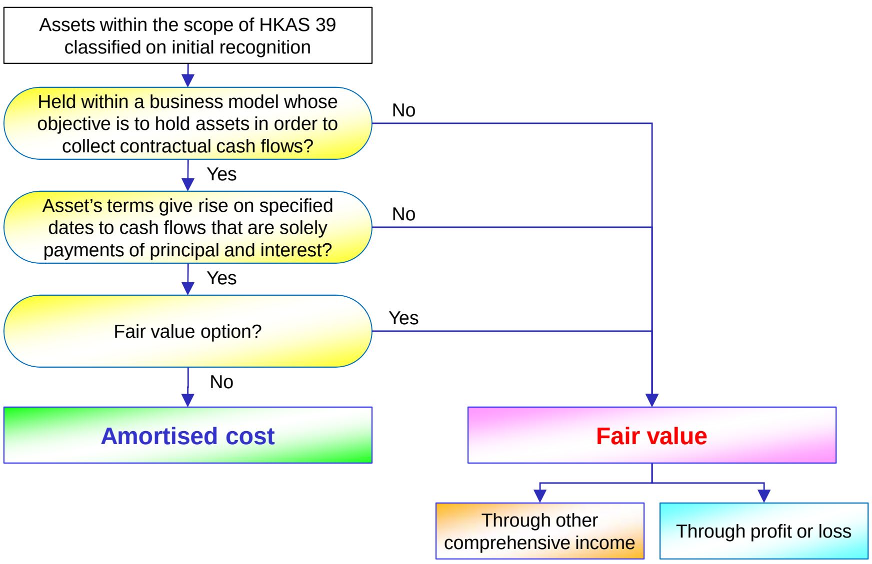
  on the basis of both:

  a) the entity’s business model for managing the financial assets; and

  b) the contractual cash flow characteristics of the financial asset. (para. 4.1)

Amortised cost | **Fair value**

Classification under HKFRS 9



Classification under HKFRS 9

Assets within the scope of HKAS 39 classified on initial recognition

Held within a business model whose objective is to hold assets in order to collect contractual cash flows?

Yes

Asset's terms give rise on specified dates to cash flows that are solely payments of principal and interest?

Yes

Amortised cost

- A financial asset shall be measured at **amortised cost** if both of the following conditions are met:
  a. the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
  b. the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. (para. 4.2)

Classification under HKFRS 9

Assets within the scope of HKAS 39 classified on initial recognition

Held within a business model whose objective is to hold assets in order to collect contractual cash flows?

No

Yes

Asset's terms give rise on specified dates to cash flows that are solely payments of principal and interest?

No

- A financial asset shall be measured at **fair value**
  – unless it is measured at amortised cost in accordance with para. 4.2. (para. 4.4)

Fair value

Classification under HKFRS 9

Assets within the scope of HKAS 39 classified on initial recognition

Held within a business model whose objective is to hold assets in order to collect contractual cash flows?

Yes

Asset's terms give rise on specified dates to cash flows that are solely payments of principal and interest?

Yes

Fair value option?

Yes → **Fair value** → Through profit or loss

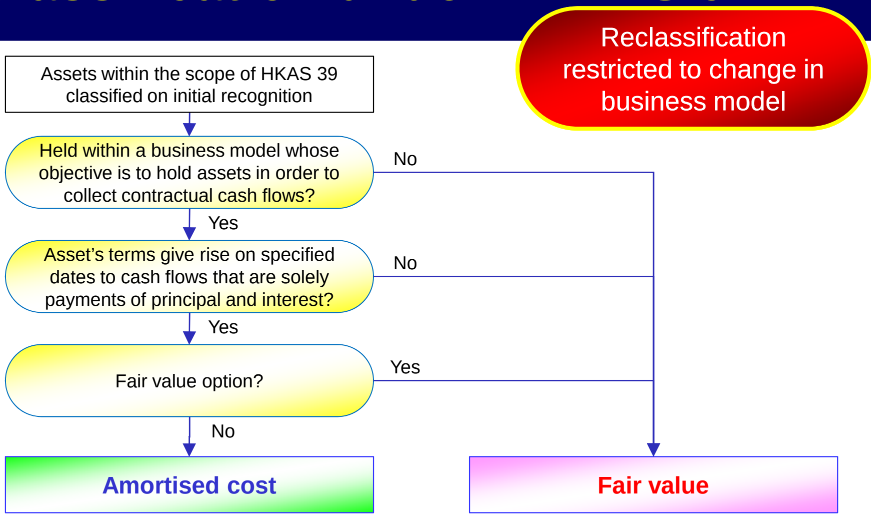
No → **Amortised cost**

- Notwithstanding para. 4.1-4.4, an entity may, at initial recognition, designate a financial asset as measured at fair value through profit or loss
  – if doing so eliminates or significantly reduces an "accounting mismatch". (para. 4.5)

Classification under HKFRS 9

- If a hybrid contract contains a host that is within the scope of this HKFRS,
  – an entity shall apply the requirements in para. 4.1-4.5 (as discussed above) to the entire hybrid contract.
- If a hybrid contract contains a host that is not within the scope of this HKFRS,
  – an entity shall apply the requirements in para. 11–13 and AG27–AG33B of HKAS 39 (as before) to determine whether it must separate the embedded derivative from the host.
- If the embedded derivative must be separated from the host, the entity shall:
  a. classify the derivative in accordance with either
     - para.4.1-4.4 for derivative assets or
     - para. 9 of HKAS 39 for all other derivatives; and
  b. account for the host in accordance with other HKFRSs.

Classification under HKFRS 9



- When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets in accordance with para. 4.1–4.4.

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

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

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.

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

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.

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.

Classification and Definitions

Case

Standard Chartered

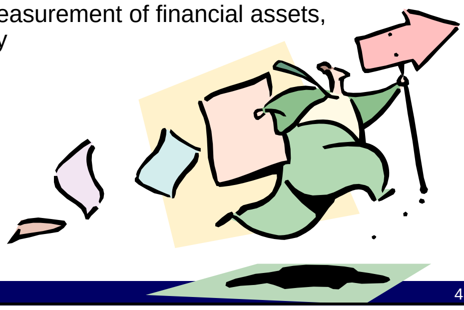
Accounting policy 2007

- 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.

Today's Agenda

Measurement

- Subsequent measurement of financial assets, financial liability



Subsequent Measurement

Based on original HKAS 39

- 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 fair values, 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

Measurement under HKFRS 9

Initial measurement (same as HKAS 39)

- At initial recognition, an entity shall measure a financial asset at
  - its fair value plus,
  - in the case of a financial asset not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset.

Initial Measurement
Fair Value
+
Transaction Cost

Measurement under HKFRS 9

Subsequent Measurement

- After initial recognition, an entity shall measure financial assets in accordance with para. 4.1 -4.5 (as discussed above) at
  - **fair value** or
  - **amortised cost**
- An entity shall apply the impairment requirements of HKAS 39 to all financial assets measured at amortised cost.
  - ➢ No impairment requirements on financial assets measured at fair value
- An entity shall apply the hedge accounting requirements of HKAS 39 to financial assets that are designated as hedged items.

Amortised cost	Fair value

Measurement under HKFRS 9

Reclassification

- If an entity reclassifies financial assets in accordance with para. 4.9 (as discussed),
  - it shall apply the reclassification *prospectively from the reclassification date*
  - the entity shall not restate any previously recognised gains, losses or interest.
- If, in accordance with para. 4.9, an entity reclassifies a financial asset so that it is measured at fair value,
  - its fair value is determined at the reclassification date
  - any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in profit or loss
- If, in accordance with para. 4.9, an entity reclassifies a financial asset so that it is measured at amortised cost,
  - its fair value at the reclassification date becomes its new carrying amount.

Measurement

- 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

Measurement

- 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

Measurement

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.

Measurement

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.

Measurement

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.

Measurement

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*

Measurement

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.

Measurement

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

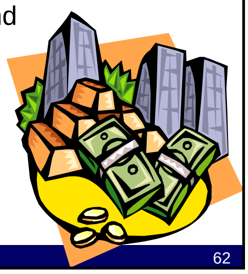
To recognise the interest income using the effective interest rate and the cash received from the 5-year debt instrument at the end of 2007.

Impairment (for Amortised Cost)

- 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 (for Amortised Cost)

- 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 (for Amortised Cost)

- 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 (for Amortised Cost)

- **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 those financial assets measured at amortised cost 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.

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

Impairment (for Amortised Cost)

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.
- 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.
- 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.

Individual Assessment

Collective Assessment

Impairment (for Amortised Cost)

- 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 (for Amortised Cost)

- 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 (for Amortised Cost)

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 (for Amortised Cost)

Example

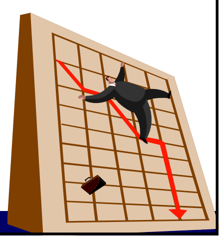
	Cash to be received as estimated at 2.1.2006	Discount factor	Present value
31.12.2006	\$ 0	$1 / (1 + 6\%)^1$	\$ 0
31.12.2007	\$ 50,000	$1 / (1 + 6\%)^2$	\$ 44,500

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 (for Amortised Cost)

- 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 (for Amortised Cost)

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 (for Amortised Cost)

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 (for Fair Value)

For Financial Assets Measured at Fair Value

- No impairment requirements

Based on HKFRS 9

Impairment under HKAS

Based on original HKAS 39

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 <u>decline in the fair value</u> of an available-for-sale financial asset has been recognised directly in equity and
  – <u>there is objective evidence that the asset is impaired</u>.
- In recognising the impairment loss on an available-for-sale financial asset, the entity
  – <u>removes the cumulative loss</u> that had been recognised directly in equity <u>from equity</u> and
  – <u>recognises the loss in profit or loss</u> even though t financial asset has not been derecognised.

Impairment under HKAS

Based on original HKAS 39

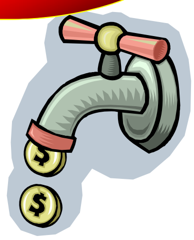
Available-for-Sale Financial Assets

- 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 under HKAS

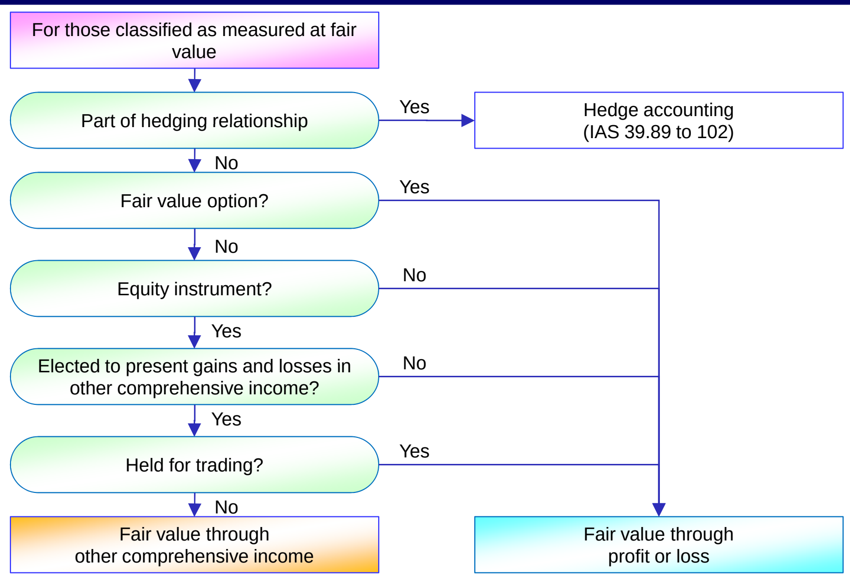
Based on original HKAS 39

Available-for-Sale Financial Assets

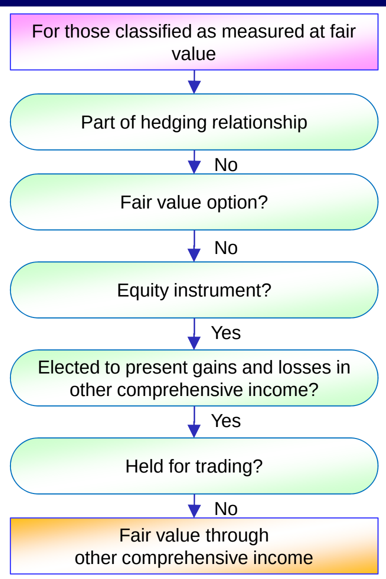


- Impairment losses on available-for-sale equity instruments
  - cannot be reversed through profit or loss (HKAS 39.69), i.e. any subsequent increase in fair value is recognised in equity.
- Reversal of the impairment loss on available-for-sale debt instrument through profit or loss is instead allowed.
  - 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.

Gains and Losses under HKFRS 9



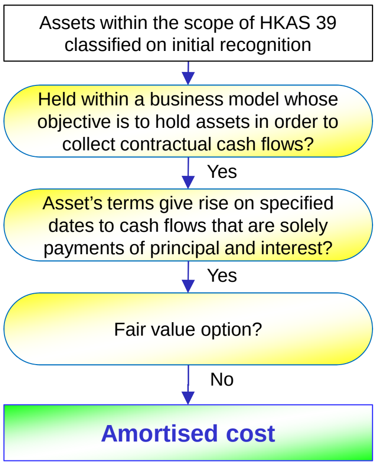
Gains and Losses under HKFRS 9



- A gain or loss on a financial asset that is measured at fair value and is not part of a hedging relationship
  - shall be recognised in **profit or loss**
  - unless :
    - the financial asset is an investment in an equity instrument and
    - the entity has elected to present gains and losses on that investment in other comprehensive income (para. 5.4.1)

Fair value through profit or loss

Gains and Losses under HKFRS 9



- A gain or loss on a financial asset that is measured at amortised cost and is not part of a hedging relationship
  - shall be recognised in profit or loss
    - when the financial asset is derecognised, impaired or reclassified, and through the amortisation process. (para. 5.4.2)

Gains and Losses under HKFRS 9

- A gain or loss on financial assets that are
  a. hedged items
     - shall be recognised in accordance with para. 89-102 of HKAS 39

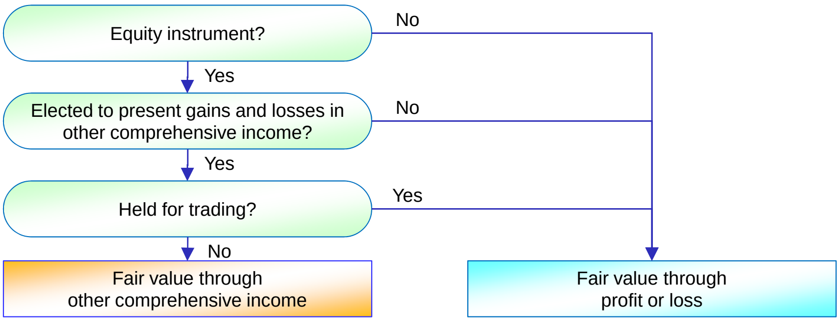
  Same as before

  b. accounted for using settlement date accounting
     - shall be recognised in accordance with para. 57 of HKAS 39

  Same as before

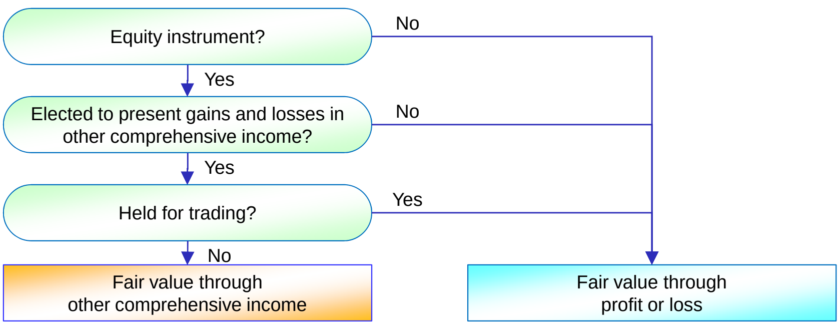
Gains and Losses under HKFRS 9

- At initial recognition, an entity may make an irrevocable election to
  - present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of HKFRS 9 that are not held for trading. (para. 5.4.4)
- If an entity makes such election, it shall recognise in profit or loss dividends from that investment when the entity's right to receive payment of the dividend is established in accordance with HKAS 18 *Revenue*. (para. 5.4.5)



Gains and Losses under HKFRS 9

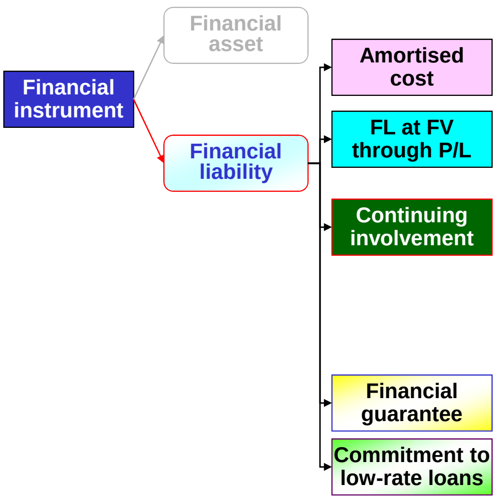
- Under HKFRS 9, amount presented in other comprehensive income shall not be subsequently transferred to profit or loss
  - Implies that
    - no recycling of any fair value change on those financial assets measured at fair value through other comprehensive income to income statement
    - no gain or loss will be recognised on derecognition of those financial assets



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

CIIH 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 <u>initially</u> recognised <u>at fair value</u> and
  - o <u>thereafter</u> stated <u>at amortised cost</u>,
    - 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 **<u>does not qualify for derecognition</u>**, or
  - – when the **<u>Continuing Involvement Approach</u>** 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.

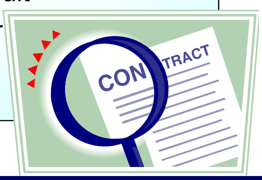
Classification of Financial Liability

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.

Financial Instruments Standards
(Part 1)

13 April 2010

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Financial Instruments Standards
(Part 1)

13 April 2010

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