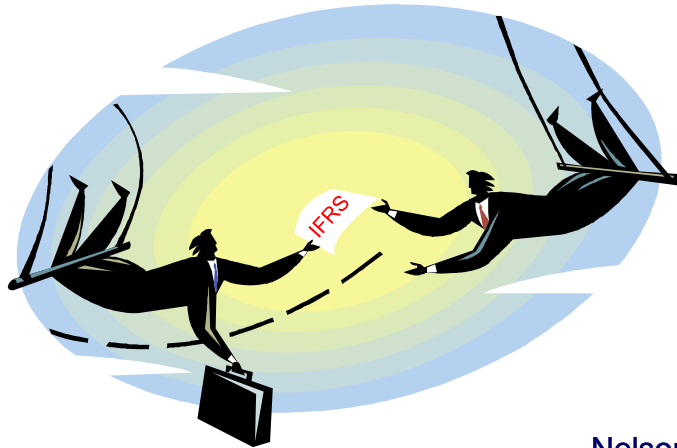


# Global Financial Reporting and Financial Tsunami

17 February 2009



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

## Today's Agenda



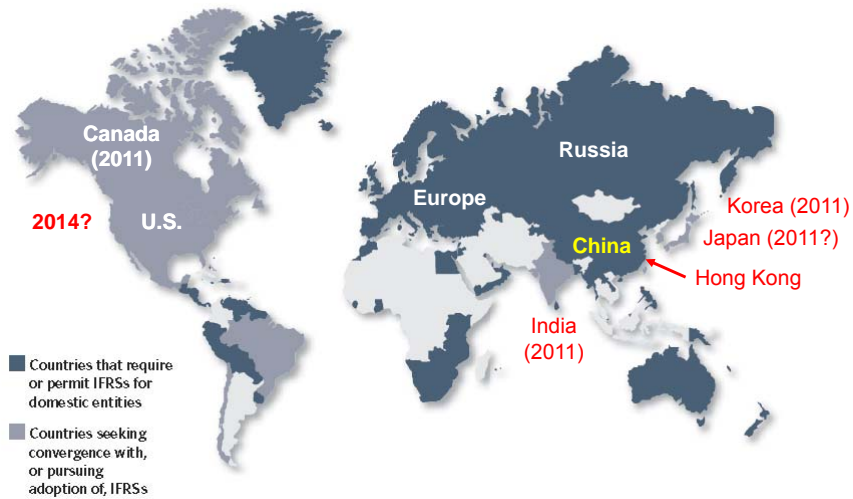
Global Trend in Financial Reporting

Brief Introduction of IFRS  
and Updates

Fair Value Debate

Global Convergence  
and Future Development

## Global Trend in Financial Reporting



© 2008-09 Nelson Consulting Limited

3

## Global Trend in Financial Reporting

- Over 100 countries or places currently require or permit the use of, or have a policy of convergence with, IFRSs
  - 2005 is a critical year as Europe began to adopt IFRS for its listed companies
  - China is one of the places regarded as having a set of “substantially the same” accounting standards (since 2007)
  - Hong Kong is one of the places fully converged to IFRS (since 2005)



© 2008-09 Nelson Consulting Limited

4

## Global Trend in Financial Reporting

- The US FASB and the IASB reaffirmed their commitment in 2005 to the convergence of US GAAP and IFRSs
- In 2007
  - the US SEC approved the financial statements from foreign private issuers in the US will be accepted without reconciliation to US GAAP only if they are prepared using IFRSs
- In 2008
  - The AICPA proposed incorporating IFRS elements in its Uniform CPA Examination
  - The AICPA launched a designated website for its members and public, [www.IFRS.com](http://www.IFRS.com)



## Global Trend in Financial Reporting

- In August 2008
  - US SEC voted to publish for public comment a proposed Roadmap to the use of IFRS by U.S. issuers
- In November 2008
  - US Roadmap to transit to IFRS released for comment
    - SEC to decide in 2011 whether to proceed with rulemaking to require that US issuers use IFRS beginning in 2014
    - Early adoption beginning with filings in 2010 would be allowed for certain issuers



# Global Trend in Financial Reporting

- Before (or even after) US and other countries have finally adopted IFRS, are there any potential issues?
  - US GAAP is converging to IFRS or IFRS converging to US GAAP
  - Pressure or impact from different countries, stakeholders, non-accounting issues .....
  - Impact of financial tsunami
  - Fair value accounting



# Global Trend in Financial Reporting

## Example

### Latest observations

- IFRS uses more US approach and/or terms
- The G20 communique said:
  - With a view towards promoting financial stability, the governance of the international accounting standard-setting body should be further enhanced .....
- Fair value accounting advocated by the IFRS is blamed for causing and/or exacerbating the current financial tsunami or credit crisis

- Converging to US

- Additional (or different role) is suggested to the IASB
- IFRS would be subject to further changes

- What's next?
- Fall back to historical cost only?
- Changes again?

# Global Trend in Financial Reporting

## Latest observations

- IFRS uses more US approach and/or terms
- The G20 communique said:
  - With a view towards promoting financial stability, the governance of the international accounting standard-setting body should be further enhanced .....
- Fair value accounting advocated by the IFRS is blamed for causing and/or exacerbating the current financial tsunami or credit crisis

Brief Introduction of IFRS and Updates

Fair Value Debate

# Today's Agenda



Brief Introduction of IFRS and Updates

# Introduction of IFRS



International  
Accounting Standards  
Board®

- **IASB** (*International Accounting Standards Board*)  
国际会计准则理事会
  - An independent and privately-funded accounting standard setter, based in London
  - Responsible to issue (负责发布) **IFRSs** (International Financial Reporting Standards) 国际财务报告准则
- **IASC** (*International Accounting Standards Committee*)  
国际会计准则委员会
  - IASB's predecessor (国际会计准则理事会的前身)
  - Responsible to issue **IASs** (International Accounting Standards) 国际会计准则
- **IFRSs** include **IASs** (国际财务报告准则包括国际会计准则)

# Introduction of IFRS

## International Financial Reporting Standards

(国际财务报告准则) are:

- Standards and Interpretations issued by the IASB and comprise:
  - International Financial Reporting Standards (IFRS 国际财务报告准则);
  - International Accounting Standards (IAS 国际会计准则); and
  - Interpretations (解释).

- On top of these, IASB also has a set of:
  - Framework for the Preparation and Presentation of Financial Statements (财务报表的编制及列报框架)

# Introduction of IFRS

## Financial Position Approach

### Financial Position (in balance sheet)

#### Asset

- a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise

#### Liability

- a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits

#### Equity

- the residual interest in the assets of the enterprise after deducting all its liabilities

### Financial Performance (in income statement)

#### Income

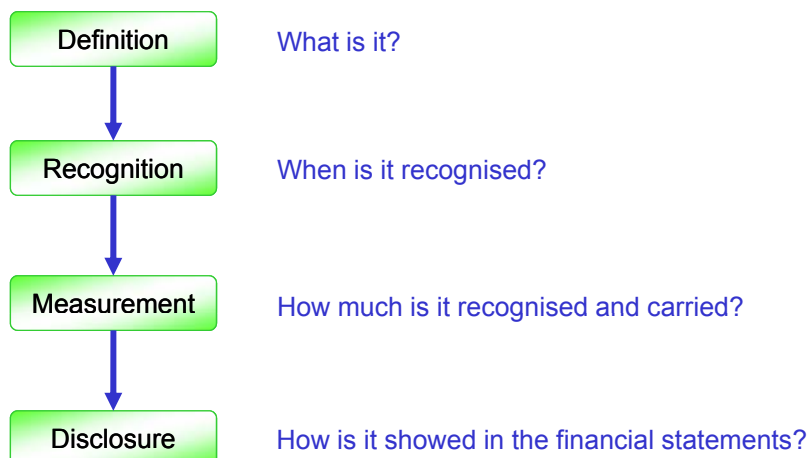
- increases in economic benefits during a period in the form of
  - inflows or enhancements of assets or
  - decreases of liabilities that result in increases in equity
  - other than those relating to contributions from equity participants

#### Expense

- decreases in economic benefits during a period in the form of
  - outflows or depletions of assets or
  - incurrences of liabilities that result in decreases in equity,
  - other than those relating to distributions to equity participants

# Introduction of IFRS

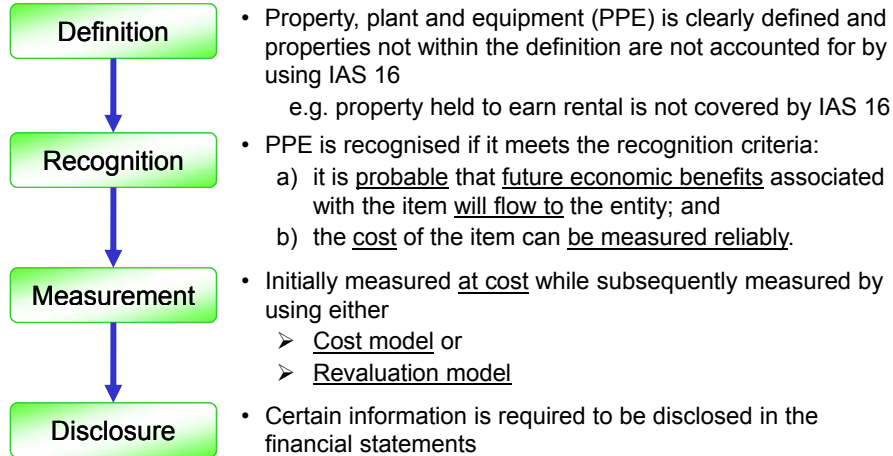
## Financial Position Approach



# Introduction: Property, Plant and E.

Example

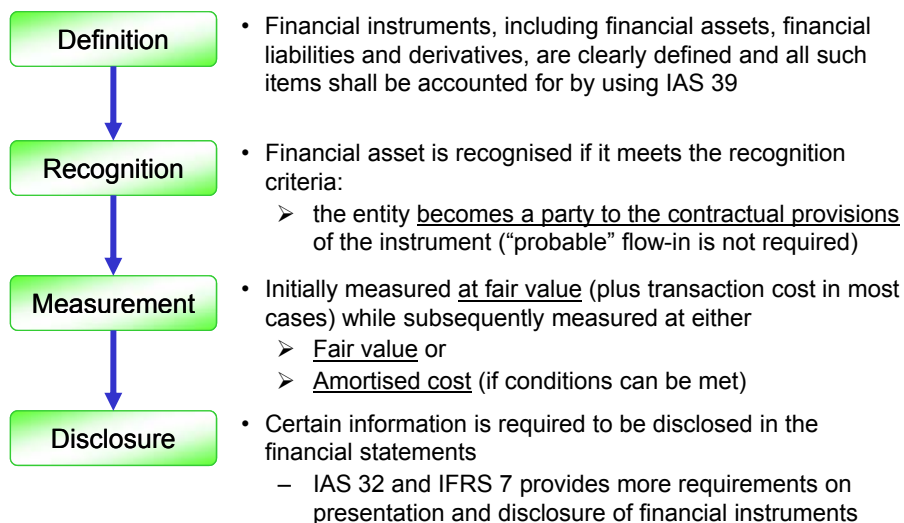
## IAS 16 Property, plant and equipment



# Introduction: Financial Assets

Example

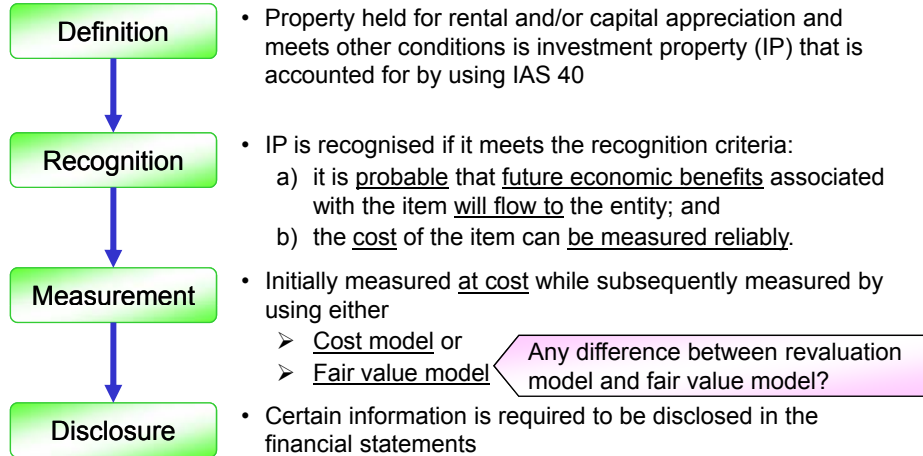
## IAS 39 Financial Instruments: Recognition and Measurement



# Introduction: Investment Property

Example

## IAS 40 Investment property



# Latest New or Amended IFRS

## Selected new interpretations and amendments to IFRS

## Effective for periods beginning on/after

• Amendments to IAS 39 and IFRS 7 <i>Reclassification of Financial Assets</i> (2008)	➢ Date back to 1 Jul. 2008
• IFRIC 15 <i>Agreements for the Construction of Real Estate</i> (2008)	➢ 1 Jan. 2009
• IFRIC 16 <i>Hedges of a Net Investment in a Foreign Operation</i> (2008)	➢ 1 Oct. 2008
• IFRS 8 <i>Operating Segments</i> (2007)	➢ 1 Jan. 2009
• IFRS 23 <i>Borrowing Costs</i> (2007)	➢ 1 Jan. 2009
• IAS 1 <i>Presentation of Financial Statements</i> (2007)	➢ 1 Jan. 2009
• IAS 27 <i>Consolidated and Separate Financial Statements</i> (2008)	➢ 1 Jul. 2009
• IFRS 3 <i>Business Combination</i> (2008)	➢ 1 Jul. 2009
• Amendments to IAS 32 and IAS 1 <i>Puttable Financial Instruments and Obligations Arising on Liquidation</i> (2008)	➢ 1 Jan. 2009
• Annual improvement to IFRSs (2008)	➢ 1 Jan. 2009

Insights & Brief Update

# Operating Segments



- IFRS 8 *Operating Segments*
  - arises from the IASB's consideration of FASB Statement No. 131 *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131 of US) issued in 1997, compared with IAS 14 *Segment Reporting*
  - achieves convergence with the requirements of SFAS 131, except for changes necessary to make the terminology consistent with that in other IFRSs

Converting to US?

# Presentation of Financial Statement

- IAS 1 *Presentation of Financial Statements* redefines a complete set of financial statements comprises:

- a statement of financial position (財務狀況表) as at the end of the period;
- a statement of comprehensive income (全面收益表) for the period;
- a statement of changes in equity for the period .....

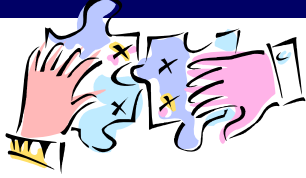
Previously, we call it "Balance sheet"

Previously, we call it "Profit or loss a/c" or "Income statement"

- Disclosure of components of other comprehensive income (其他全面收益) and total comprehensive income (全面收益)
- Tax effect is also considered and disclosed for gains and losses not recognised in profit or loss

Comprehensive income concept used in US since 90s

## Business Combinations



- IFRS 3 *Business Combinations*
  - clarify the meaning of business and recognition of identifiable net assets
  - advocate the use of “fair value” of an entity as a going concern (instead of the fair value of an entity’s net assets only) to derive:
    - the non-controlling interests (minority interests) and
    - goodwill

Fair Value Accounting  
extended to non-  
controlling interests and  
goodwill

## Reclassification of Financial Assets

- An amendment issued in Oct. 2008 to amend IAS 39 and IFRS 7
  - Obviously, it was issued because of the current financial crisis
  - Usual due process was not followed
  - Allow entity to reclassify something that were not allowed to reclassify before
    - e.g. reclassify non-derivative financial assets held for trading to avoid the decline in fair value to be recognised in profit or loss
  - Effective date dated back to 1 July 2008



Addressing to financial  
tsunami?

# Reclassification of Financial Assets

## Reclassification

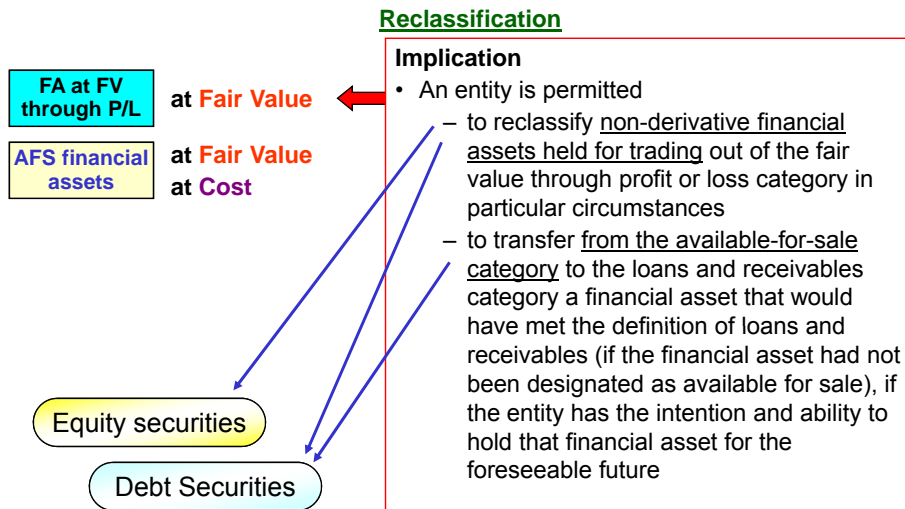
FA at FV through P/L	at Fair Value	← An entity shall <b>NOT</b> reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.
AFS financial assets	at Fair Value at Cost	
Loans and receivables	at Amortised Cost	← Not described in IAS 39 but, implicitly, it is not feasible to reclassify a financial into or out of loans and receivables
HTM investments	at Amortised Cost	

# Reclassification of Financial Assets

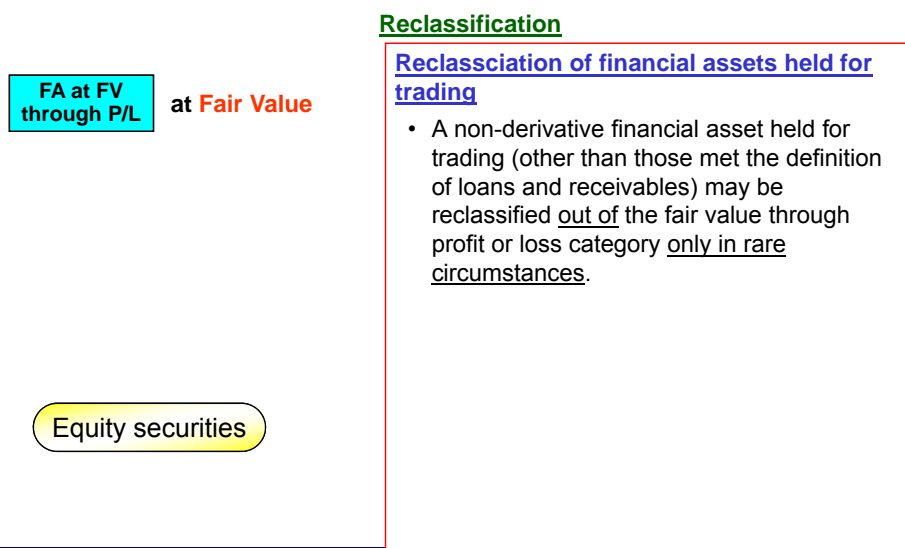
## Reclassification

FA at FV through P/L	at Fair Value	← From 1 July 2008 (issued in Oct 2008) .....
<p>An entity:</p> <ol style="list-style-type: none"> <li>shall <u>not reclassify a derivative out of</u> the fair value through profit or loss category while it is held or issued.;</li> <li>shall <u>not reclassify any financial instrument out of</u> the fair value through profit or loss category if upon initial recognition it <u>was designated</u> by the entity as at fair value through profit or loss; and</li> <li><u>may</u>, if a financial asset is <u>no longer held for the purpose of selling or repurchasing it in the near term</u> (notwithstanding that the financial asset may have been acquired or incurred principally for the purpose of selling or repurchasing it in the near term), <u>reclassify that financial asset out of the fair value through profit or loss category</u> if the requirements in HKAS 39.50B or 50D are met.</li> </ol> <p>An entity shall <u>not reclassify any financial instrument into</u> the fair value through profit or loss category after initial recognition.</p>		

# Reclassification of Financial Assets



# Reclassification of Financial Assets



# Reclassification of Financial Assets

FA at FV through P/L

at Fair Value

Equity securities

## Reclassification

### Measurement on the reclassification date

- If an entity reclassifies a financial asset out of the fair value through profit or loss category,
  - the financial asset shall be reclassified at its fair value on the date of reclassification.
- Any gain or loss already recognised in profit or loss shall not be reversed.
- The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable.

# Reclassification of Financial Assets

FA at FV through P/L

at Fair Value

AFS financial assets

at Fair Value  
at Cost

Loans and receivables

at Amortised Cost

Debt Securities

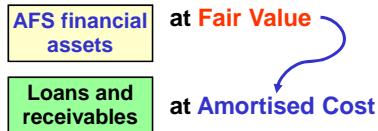
## Reclassification

### For financial assets met the definition of loans and receivables (from the fair value through profit or loss category)

- A financial asset to be reclassified that would have met the definition of loans and receivables (if the financial asset had not been required to be classified as held for trading at initial recognition) may be reclassified out of the fair value through profit or loss category
  - if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

# Reclassification of Financial Assets

## Reclassification



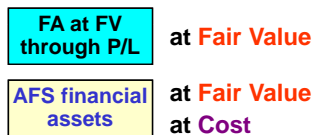
Debt Securities

### For financial assets met the definition of loans and receivables (from available-for-sale)

- A financial asset classified as available for sale that would have met the definition of loans and receivables (if it had not been designated as available for sale) may be reclassified out of the available-for-sale category to the loans and receivables category
  - if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

# Reclassification of Financial Assets

## Reclassification



Debt Securities

### For financial assets met the definition of loans and receivables

- If an entity reclassifies a financial asset out of the fair value through profit or loss category (HKAS 39.50D) or out of the available-for-sale category (HKAS 39.50E),
  - it shall reclassify the financial asset at its fair value on the date of reclassification.

# Reclassification of Financial Assets

FA at FV through P/L at Fair Value

AFS financial assets at Fair Value at Cost

Debt Securities

## Reclassification

- For a financial asset out of the fair value through profit or loss category (HKAS 39.50D),
  - any gain or loss already recognised in profit or loss shall not be reversed
  - the fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable.
- For a financial asset reclassified or out of the available-for-sale category (HKAS 39.50E),
  - any previous gain or loss on that asset that has been recognised in other comprehensive income (or equity) shall be accounted for in accordance with HKAS 39.54 (to be discussed next).

# Reclassification of Financial Assets

FA at FV through P/L at Fair Value

AFS financial assets at Fair Value at Cost

Debt Securities

## Reclassification

- The fair value carrying amount of the asset on that date becomes its new cost or amortised cost, as applicable
- Any previous gain or loss on that asset that has been recognised directly in equity shall be accounted for as follows:
  - a) In the case of a financial asset with a fixed maturity
    - the gain or loss shall be amortised to P/L over the remaining life of the HTM investment using the effective interest method.
  - b) In the case of a financial asset that does not have a fixed maturity
    - the gain or loss shall remain in equity until the financial asset is sold or otherwise disposed of, when it shall be recognised in P/L.

# Reclassification of Financial Assets

## Effective Date and Transition

- Reclassification of Financial Assets (Amendments to HKAS 39 and HKFRS 7), issued in October 2008, amended HKAS 39.50 and AG8, and added HKAS 39.50B–50F.
- An entity shall apply those amendments (from) on or after 1 July 2008.
- An entity shall not reclassify a financial asset in accordance with HKAS 39.50B, 50D or 50E before 1 July 2008.
- Any reclassification of a financial asset made (in periods beginning) on or after 1 November 2008 shall take effect only from the date when the reclassification is made.
- Any reclassification of a financial asset in accordance with HKAS 39.50B, 50D or 50E shall not be applied retrospectively before 1 July 2008 (to reporting periods ended before the effective date set out in this paragraph).



# Latest New or Amended IFRS

- Changes still confirm some general features of IFRS
  - Financial position (balance sheet) approach
  - Re-measure assets to fair value in the statement of financial position (balance sheet)
  - Income statement and profit or loss become a residue
    - Volatile or unstable?
  - New assets, new liabilities, new gains, new expenses
    - Certain off-balance sheet items are no longer “off” and should be recognised “on” balance sheet
  - New practices, new disclosure

..... affecting all stakeholders



## Latest New or Amended IFRS

Recap of observations

- Political impact: changes resulted from financial tsunami ..... more?
- US impact: converting to IFRS or converting to US
- Fair value accounting: more?
- Changes seem inevitable, right?

Correlated?



Fair Value Debate

## Today's Agenda

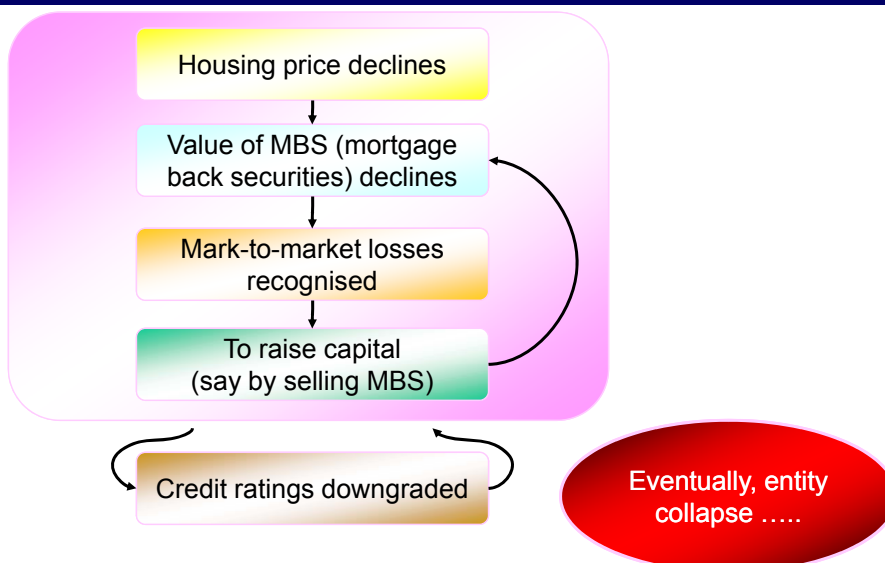


Fair Value Debate

## Fair Value Debate

- Views blame that the fair value accounting rule is one of the causes and/or exacerbates the current financial tsunami
  - The Economic Times explains their argument like that:
    - “In the current crisis, declining housing prices reduced the value of all mortgage based securities (MBS), since the housing collateral protecting them is much less.”
    - “Because of the mark-to-market losses, companies have to raise capital for meeting capital adequacy requirements.”
    - “When MBS or other assets are sold to raise capital, the market value is driven down further.”
    - “Worse still, the distress prices becomes the new price for valuation of all similar instruments held by all companies.”
    - “This domino effect results in a downward death spiral.”
    - “The credit rating agencies downgrade the company's credit ratings, making borrowing to meet capital requirements more difficult”
    - “ This eventually results in the collapse of the company.”

## Fair Value Debate



## Fair Value: What is it?



- Fair value is used or mentioned in most IFRSs
- **Fair value** is defined as:
  - the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction

## Fair Value: What is it?



- The same definition is used in different IFRSs,
  - The application to different assets and liabilities may not be the same, for example:
    - IAS 16 *Property, plant and equipment*
    - IAS 18 *Revenue*
    - IAS 39 *Financial instruments: recognition & measurement*
    - IAS 40 *Investment property*
    - IFRS 2 *Share-based payment*

# Fair Value: What is it?

## Example

- Fair value can be applied to
  - initial measurement,
  - subsequent measurement, or
  - both

Applied to both initial and subsequent measurement:

- Inventories (IAS 2)
- Financial assets and liabilities at fair value through P/L (IAS 39)
- Available for sale financial assets (IAS 39)
- Agriculture (IAS 41)

Applied to initial measurement but not subsequent measurement:

- Held-to-maturity (IAS 39)
- Loans and receivables (IAS 39)
- Business combination (IFRS 3)

Not applied to initial measurement but applied to subsequent measurement (incl. selective):

- Property, plant and equipment (IAS 16)
- Intangible assets (IAS 38)
- Investment property (IAS 40)

# Fair Value: What is it?

## Example

### Fair value model (e.g. IAS 40)

- Refers to fair value
- Changes in fair value recognised in profit or loss
- No depreciation or amortisation is required
- Revalued at each reporting date
- N/A

### Revaluation model (e.g. IAS 16)

- Refers to fair value
- Changes in fair value recognised in equity (or other comprehensive income)
- Depreciation or amortisation is required
- Not clearly defined, only require sufficient regular that no material different from fair value
- Deficit about fair value below depreciated cost is recognised in profit or loss

## Fair Value Debate

- William Isaac, Past Chairman of the US Federal Insurance Deposit Corp. complained that fair value accounting or mark-to-market rule is the chief culprit in the global financial crisis and “should be withdrawn immediately”, noting “hundreds of billions of dollars have been lost because of these rules.” *(A Plus Dec. 2008)*



- FASB Chairman Bob Herz said: “The concept of fair value, which was intended to help bring transparency, was scorned by some as a villain, exacerbating the (economic) turmoil, and heralded by others as a savior in revealing the problems on a timely basis” *(Journal of Accountancy Dec. 2008)*

## Fair Value Debate

- Sir David Tweedie even nearly quit from the Chairman of the International Accounting Standard Board due to political pressure from the European Commission that forced to changes in fair value accounting rules *(Financial Times Nov. 2008)*



- France supported by some countries within European Commission was lobbying very hard for changes in IFRS, in particular IAS 39, i.e. including fair value accounting rule. *(A Plus Dec. 2008)*

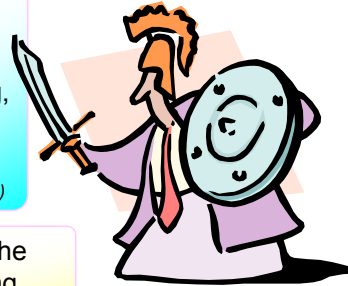
- The American Bankers Association is currently the leading critic, saying that fair value has exaggerated losses at financial institutions. *(Financial Week Oct. 2008)*

## Fair Value Debate: Defend

- “Admittedly, fair value measurement is not a perfect system ..... But calls to scrap or suspend the implementation of fair value rules are unwarranted.”  
(CFA Magazine, Jul-Aug 2008)

- “However, those criticising fair value accounting do not seem to provide any credible alternatives.”
- “Do we go back to historical cost accounting, wherein the financial assets are stated at outdated values and hence are not relevant or reliable?”  
(The Economic Times, 21 Nov. 08)

- US SEC Chairman, Christopher Cox, said “the current concept of mark-to-market accounting increases the transparency of financial information.”  
(InvestorNews Dec. 2008)



## Fair Value Debate: Steps Taken

- The IASB has committed itself to undertake:
  - Permitting the possibility of reclassification of certain financial instruments to align IFRS with US GAAP (as discussed previously)
  - Formation of an international advisory group jointly with US FASB
  - Organisation of public round tables in Asia, Europe and North America
  - Work closely with the FASB to develop a common approach to accounting questions related to the valuation of financial assets and liabilities resulting from purchases made through the US Emergency Economic Stabilization Act of Act 2008 (the bailout plan) and any other similar programmes internationally  
(<http://www.iasb.org/About+Us/About+the+IASB/Response+to+the+credit+crisis.htm>)



## Fair Value Debate: Steps Taken



- The US SEC (and FASB) have taken the following:
  - SEC issued a clarification on fair value accounting in Sep. 2008
  - FASB Staff Position released in Oct. 2008
- On 30 Dec. 2008, the SEC delivered a report to Congress (as mandated by the Emergency Economic Stabilization Act of 2008)
  - recommended against the suspension of fair value accounting
  - rather, suggested having improvements to existing practice, incl.:
    - reconsidering the accounting for impairments
    - developing additional guidance for determining fair value of investments in inactive markets (<http://www.sec.gov/news/press/2008/2008-307.htm> and <http://www.sec.gov/news/studies/2008/marktomarket123008.pdf>)

## Fair Value Debate: Steps Taken



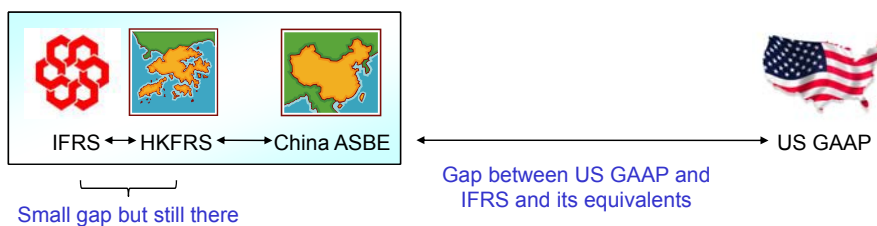
- SEC reported that:
  - investors generally believe fair value accounting increases financial reporting transparency and facilitates better investment decision-making
  - fair value accounting did not appear to play a meaningful role in the bank failures that occurred in 2008
  - bank failures in the U.S. appeared to be the result of growing probable credit losses, concerns about asset quality, and in certain cases, eroding lender and investor confidence

# Today's Agenda



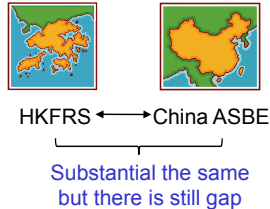
Global Convergence  
and Future Development

## Convergence in China and HK



- In HK, in essence, for the majority of companies, financial statements prepared in accordance with HKFRSs are for all intents and purposes identical to financial statements prepared in accordance with IFRS.
  - However, this does not automatically entitle such companies to include an unreserved statement of compliance with IFRSs in their financial statements.
  - Because most companies might have not applied IFRS 1 (when first applied in 2005) as they have continuously applied HKFRSs which have transitional provisions being difference from IFRS 1.

## Convergence in China and HK



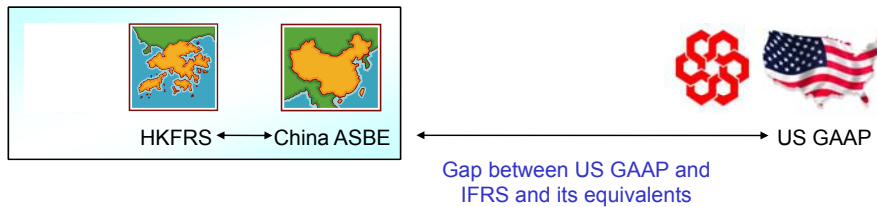
- China Accounting Standards for Business Enterprises (ASBE) are substantially in line with IFRSs (趋同)
  - except for certain modifications that reflect China's unique circumstances and environment
- Critical differences from IFRS and HKFRS include:
  - Definition of related party
  - Reversal of impairment loss is not allowed in China ASBE
  - Fair value rule is not used in some areas .....

## Convergence in China and HK



- A joint statement of China Accounting Standards Committee (CASC) and HK Institute of CPAs (HKICPA) in Dec. 2007 stated that:
  - Financial statements prepared in accordance with ASBEs effective on 6 Dec. 2007, after adjusting for the reconciliation differences relating to reversal of impairment losses on assets and related party disclosures where applicable, should achieve substantially the same effect as those prepared in accordance with HKFRSs effective on the same date
  - Both parties declare their commitment to eliminate the above two differences and maintain the convergence of ASBEs and HKFRSs on an ongoing basis; and for that purpose, have established a mechanism for ongoing maintenance of convergence .....

## Convergence in China and HK



**Changes .....  
seems inevitable and  
continuous**

## Convergence in China and HK

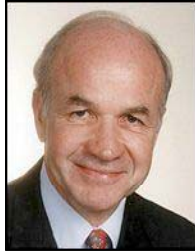


- Converting between US GAAP and IFRS .....
- G7 recommended 67 issues for enhancing market and institutional resilience and 3 out of them related to enhancements to financial reporting.
  - IASB has stated those recommendations form the core of its response to the credit crisis:
    1. Improve the accounting and disclosure standards for off balance sheet vehicles
    2. Enhance its guidance on valuing financial instruments when markets are no longer active
    3. Strengthen the standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations

# You Know Them?



Nick Lesson



Kenneth Lay

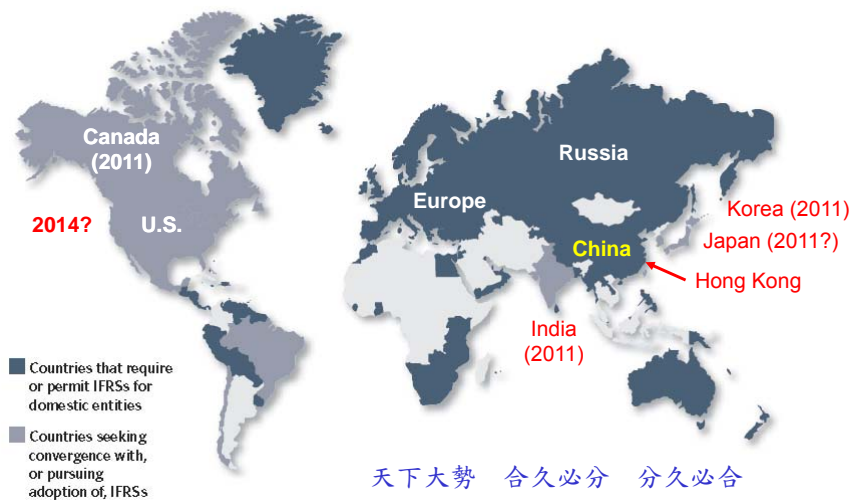


Jerome Kerviel



Richard Fuld

# 同一個世界，同一套準則 .....



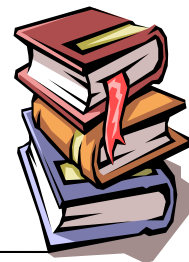
## 同一個世界，同一套準則 .....

路漫漫其修遠兮  
吾將上下而求索

屈原《離騷》  
(340-278 B.C.)



"There is a long road,  
we keep on search here and there."  
Li Sao of Qu Yuan (340-278 B.C.)

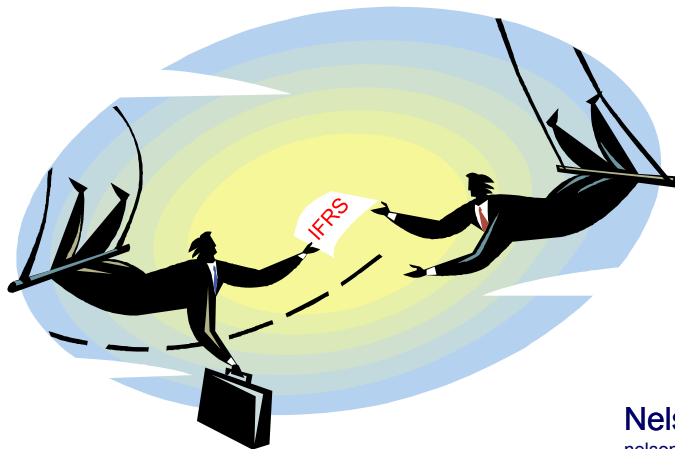


© 2008-09 Nelson Consulting Limited

57

## Global Financial Reporting and Financial Tsunami

17 February 2009



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

© 2008-09 Nelson Consulting Limited

58