Financial Instruments: Recap & Update
(Part 1) 7 September 2011

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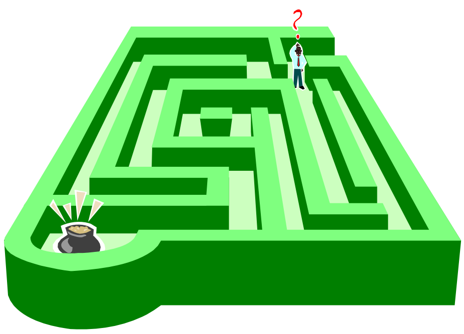
HKAS 32, HKAS 39, HKFRS 7 and HKFRS 9

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

Professor Sir David Tweedie
Chairman of IASB



Background

- 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.

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Background

- The three main phases of the project to replace HKAS 39 are:
  a) Phase 1: Classification and measurement of financial assets and financial liabilities.
  b) Phase 2: Impairment methodology.
  c) Phase 3: Hedge accounting.
- HKFRS 9 issued so far includes only the chapters relating to Phase 1 (classification and measurement of financial assets and financial liabilities).

Additions of Financial Liabilities issued on 25 Nov. 2010 in HK

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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)*~~
7 ~~8~~ Effective Date and Transition

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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

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Background

- Under HKFRS 9, an entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when,
  - the entity becomes party to the contractual provisions of the instrument.
- When an entity first recognises a financial asset, it shall
  - **classify** it in accordance with paragraphs 4.1.1-4.1.5 and
  - **measure** it in accordance with paragraph 5.1.1 and 5.1.2.
- When an entity first recognises a financial liability, it shall
  - **classify** it in accordance with paragraphs 4.2.1 and 4.2.2 and
  - **measure** it in accordance with paragraph 5.1.1.

  (para. 3.1.1)

Same as before

Amended (Ch. 4 of HKFRS 9)

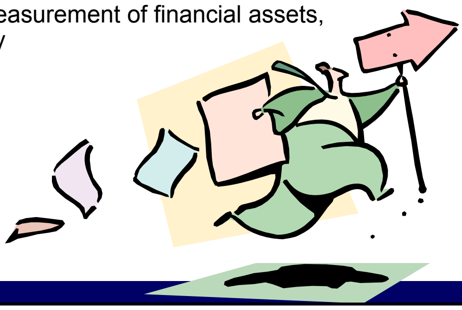
Amended (Ch. 5 of HKFRS 9)

Similar to HKAS 39

Same para. as financial assets

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

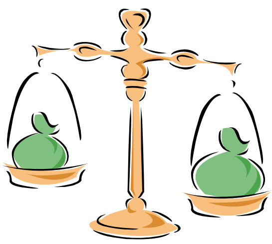
Forward contracts
- as if financial instruments
- within scope

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

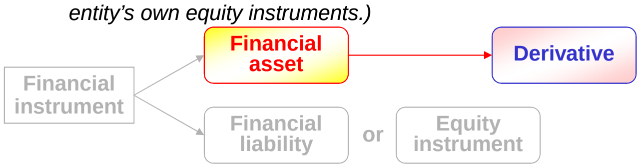


Financial instrument
- **Financial asset** → **of one entity**
- **Financial liability** or **Equity instrument** → **of another entity**

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.)*



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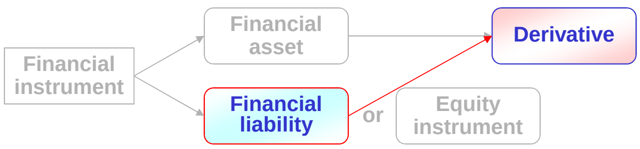
Scope – What is Financial Instrument?

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.)*



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Scope – What is Financial Instrument?

Financial liability is any liability that is

- A contract that will or may be 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, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also for these purposes the entity's own equity instruments ......

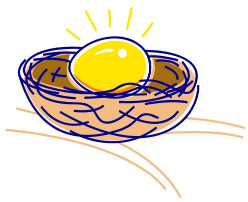
include instruments tha… mselves contracts for the future receipt or delivery of the entity's own equit…

Add a new sentence …

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

Scope – What is Financial Instrument?

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



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

Scope – What is Financial Instrument?

Example

Gold Bullion

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

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

Financial instrument → Financial asset | Derivative
Financial instrument → Financial liability or Equity instrument

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, the entity becomes a party to the contractual provisions of the instrument.
- In other accounting standards, the recognition criteria are
  1) it is probable that future economic benefits associated with the item will flow to (or flow out from) the entity; and
  2) the cost of the item can be measured reliably.

Imply trade date accounting

Imply settlement date accounting

Financial instrument → Financial asset

Financial instrument → Financial liability

Initial Recognition & Measurement

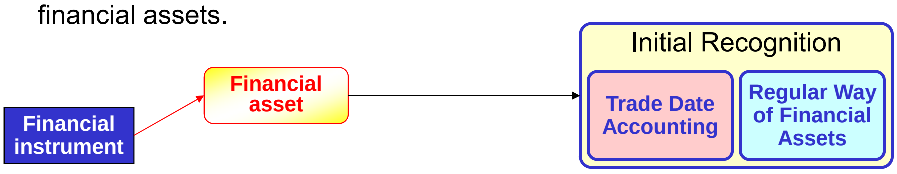
- For financial assets, an entity can choose to recognise and derecognise a financial asset either using trade date accounting or settlement date accounting if it is a regular way purchase or sale of financial asset
- A regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Financial instrument → Financial asset → Initial Recognition

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

Initial Recognition & Measurement

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



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Initial Recognition & Measurement

- For both financial assets and financial liabilities, HKAS 39 has
  – <u>the same initial recognition requirements</u>
  – <u>the same initial measurement basis</u>
- 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 **<u>fair value</u>** plus
  2. its **<u>transactions costs</u>** that are directly attributable to the acquisition or issue of the financial asset or financial liability

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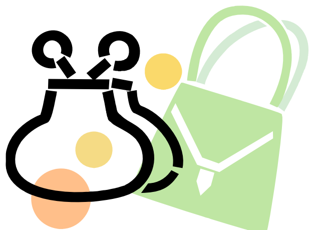
Initial Recognition & Measurement

- 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.



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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.

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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.

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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.

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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.

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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

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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

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Today's Agenda

Classification

- Classification of financial assets, financial liability and equity

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Classification under HKAS 39

Based on original HKAS 39

- Financial instrument
  - Financial asset
    - FA at FV through P/L
    - AFS financial assets
    - Loans and receivables
    - HTM investments
  - Financial liability

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.

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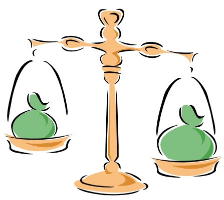
Classification under HKAS 39

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

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Classification under HKAS 39

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 HKAS 39

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

3 conditions to qualify as investments in equity instruments without fair value:

1. The asset is an equity instrument
2. No active market for the asset
3. Fair value of the asset cannot be reliably measured

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

FA at FV through P/L

AFS financial assets

Loans and receivables

HTM investments

Classification under HKAS 39

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

No

Classified as held for trading

Three situations to be held for trading:

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

FA at FV through P/L

Held for trading

Classification under HKAS 39

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

No

Classified as held for trading

No

Designated as at fair value through profit or loss

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

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

FA at FV through P/L

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

Designation

Classification under HKAS 39

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

No

Classified as held for trading

No

Designated as at fair value through profit or loss

No

Designated as available for sale

Non-derivative financial asset
- Implicitly, the designation is made at initial recognition

AFS financial assets

Classification under HKAS 39

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

No

Designated as at fair value through profit or loss

No

Designated as available for sale

Yes → Available-for-sale financial assets (at fair value through equity)

AFS financial assets

No

Meet the definition of loans and receivables

No

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

No

Residual category

Classification under HKAS 39

Based on original HKAS 39

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

AFS financial assets

Classification under HKAS 39

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

No ↓

Classified as held for trading

No ↓

Designated as at fair value through profit or loss

No ↓

Designated as available for sale

No ↓

Meet the definition of loans and receivables

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

Loans and receivables

Classification under HKAS 39

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
No ↓
Classified as held for trading
No ↓
Designated as at fair value through profit or loss
No ↓
Designated as available for sale
No ↓
Meet the definition of loans and receivables
No ↓
Meet the definition and tainting rule of held-to-maturity investments ←

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

HTM investments

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Classification under HKFRS 9

- Unless para. 4.1.5 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. 4.1.1)

Amortised cost | **Fair value**

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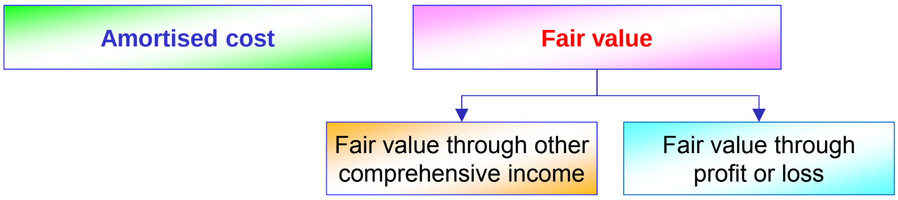
Classification under HKFRS 9

- Even the common understanding views that there are two categories in HKFRS 9 for the classification and subsequent measurement of a financial asset, a financial asset can be classified into the following four categories or sub-categories:
  1. Designated as at fair value through profit or loss; and
  2. Classified as at:
     a. Amortised cost;
     b. Fair value through profit or loss; and
     c. Fair value through other comprehensive income.



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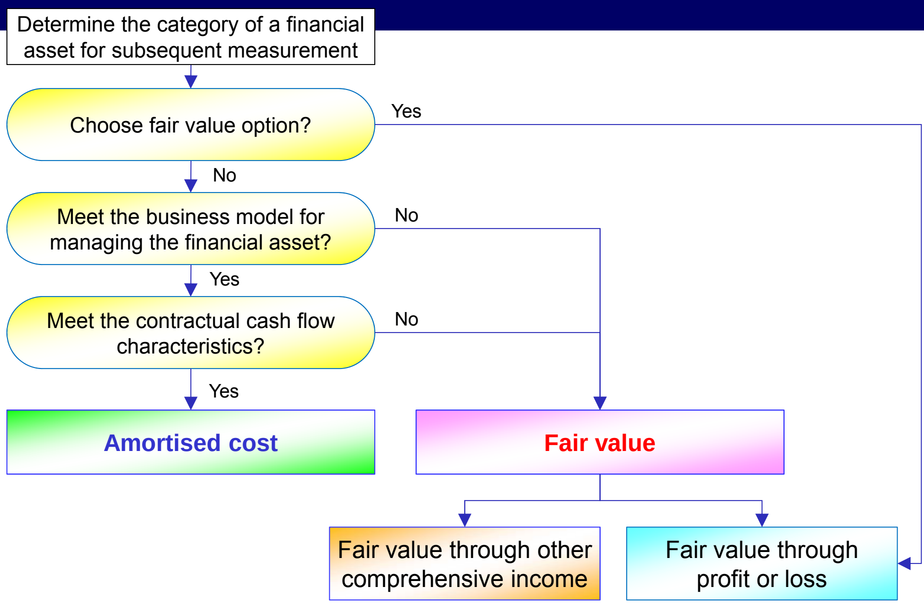
Classification under HKFRS 9



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Classification under HKFRS 9

- Determine the category of a financial asset for subsequent measurement
- Choose fair value option? → Yes
- To eliminate or significantly reduce an accounting mismatch

- Despite para. 4.1.1-4.1.4, 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 a measurement or recognition inconsistency (i.e. an "accounting mismatch"). (para. 4.1.5)

Fair value

Fair value through profit or loss

- This option
  - is termed as "fair value option" and
  - is an accounting policy choice.

Classification under HKFRS 9

- Determine the category of a financial asset for subsequent measurement
- Choose fair value option? → No
- Meet the business model for managing the financial asset? → Yes
- Meet the contractual cash flow characteristics? → 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. 4.1.2)

Classification under HKFRS 9

Determine the category of a financial asset for subsequent measurement

Choose fair value option?

No

Meet the business model for managing the financial asset?

Yes

Meet the contractual cash flow characteristics?

Yes

Amortised cost

- Determined by key management personnel
- Not instrument-by-instrument basis
- No held for trading

- An asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows

- Contractual terms of an asset give rise on specified dates to cash flows that are solely payments of principal and interest

- Interest for the time value of money and the credit risk
- Unleveraged

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Classification under HKFRS 9

Meet the business model for managing the financial asset?

- Assesses the basis of the objective of the business model as determined by the entity's key management personnel (as defined in HKAS 24 *Related Party Disclosures*). (para. B4.1.1)

- The entity's business model does not depend on management's intentions for an individual instrument.
  - Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation.
  - However, a single entity may have more than one business model for managing its financial instruments.
  - Therefore, classification need not be determined at the reporting entity level. (para. B4.1.2)

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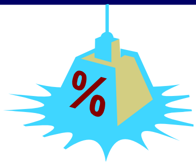
Classification under HKFRS 9



Meet the business model for managing the financial asset?

- Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows,
  - the entity need not hold all of those instruments until maturity.
    - Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur.
- However, if more than an infrequent number of sales are made out of a portfolio,
  - the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows. (para. B4.1.3)

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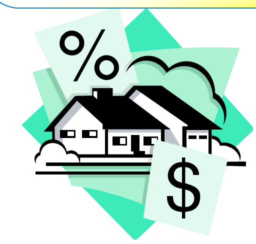
Classification under HKFRS 9

Meet the business model for managing the financial asset?

↓

Meet the contractual cash flow characteristics?



- Interest is consideration
  - for the time value of money and
  - for the credit risk associated with the principal amount outstanding during a particular period of time. (para. 4.1.3)
- Contractual cash flows are assessed on the currency in which the financial asset is denominated. (para. B4.1.8)

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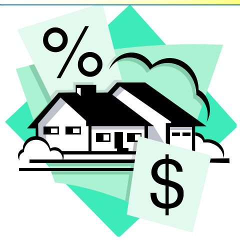
Classification under HKFRS 9

Meet the contractual cash flow characteristics?



- Financial assets including leverage do not meet this condition and cannot be subsequently measured at amortised cost.
  - Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest.
  - Stand-alone option, forward and swap contracts are examples of financial assets that include leverage.
    (para. B4.1.9)

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Classification under HKFRS 9

Determine the category of a financial asset for subsequent measurement

Choose fair value option?

No

Meet the business model for managing the financial asset?

No

Yes

Meet the contractual cash flow characteristics?

No

Fair value

Fair value through profit or loss

- A financial asset shall be measured at **fair value**
  - unless it is measured at amortised cost in accordance with para. 4.1.2.
    (para. 4.1.4)

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Classification under HKFRS 9

- The category of financial assets at fair value through profit or loss is composed of at least three groups of financial assets and they are:
  1. Financial assets designated at fair value through profit or loss by an entity;
  2. Financial assets measured at fair value but unable to be measured through other comprehensive income; and
  3. Financial assets held for trading, including derivatives.

Fair value

↓

Fair value through profit or loss

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Classification under HKFRS 9

Case

香港交易所 HKEx

Financial statements 2009 states that:

- In the fourth quarter of 2009, the Group early adopted all new/revised HKFRSs issued up to 31 December 2009 which were pertinent to its operations where early adoption is permitted.
- The applicable HKFRSs are set out below:
  – HKFRS 9: Financial Instruments ……
- HKFRS 9 is the first part of a project to replace HKAS 39: *Financial Instruments: Recognition and Measurement*, and it replaces the classification and measurement requirements in HKAS 39 for financial assets.

Amortised cost | **Fair value**

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Classification under HKFRS 9

Case

Financial statements 2009 states that:

- Previously, financial assets of the Group were classified as financial assets at
  - fair value through profit or loss,
  - available-for-sale financial assets or
  - loans and receivables (which included bank deposits) ……
- The early adoption of HKFRS 9 has resulted in a change in accounting policy, and financial assets are classified into
  - financial assets measured at fair value through profit or loss or
  - financial assets measured at amortised cost.

Amortised cost

Fair value

→ Fair value through profit or loss

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Classification under HKFRS 9

- An entity is required to measure all financial assets at fair value through profit or loss
  - unless a financial asset meets the following conditions:
    1. The financial asset is an investment in an equity instrument; and
    2. The entity has made an irrevocable election to present gains and losses on that investment in other comprehensive income. (para. 5.7.1)
       - 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 is not held for trading (to be discussed more later).

Fair value

→ Fair value through other comprehensive income

→ Fair value through profit or loss

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Classification under HKFRS 9

Case

香港交易所 HKEx

Financial statements 2009 states that:

- Following the adoption of HKFRS 9, investments and other financial assets of the Group extant at 31 December 2009 are classified under the following categories:
  - Financial assets measured at amortised cost

    Investments are classified under this category if they satisfy both of the following conditions:
    - the assets are held within a business model whose objective is to hold assets in order to collect contractual cash flows for managing liquidity and generating income on its investment, but not for the purpose of realising fair value gains; and
    - the contractual terms of the financial assets give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, with interest being the consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time and are unleveraged.

    Bank deposits, trade and accounts receivable and other deposits are also classified under this category.

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Classification under HKFRS 9

Case

香港交易所 HKEx

Financial statements 2009 states that:

- Financial assets measured at fair value through profit or loss

  Investments and other financial assets are classified under this category if they do not meet the conditions to be measured at amortised cost.

  Securities or bank deposits with embedded derivatives are classified in their entirety as measured at fair value through profit or loss, where the economic characteristics and risks of the embedded derivatives are dissimilar to those of the host contracts and modify the contractual cash flows, such that they are not solely payments of principal and interest on the principal amount outstanding or the interest rate does not reflect only consideration for the time value of money and credit risk.

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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

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.

What is the impact of HKFRS 13 *Fair Value Measurement*?

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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.

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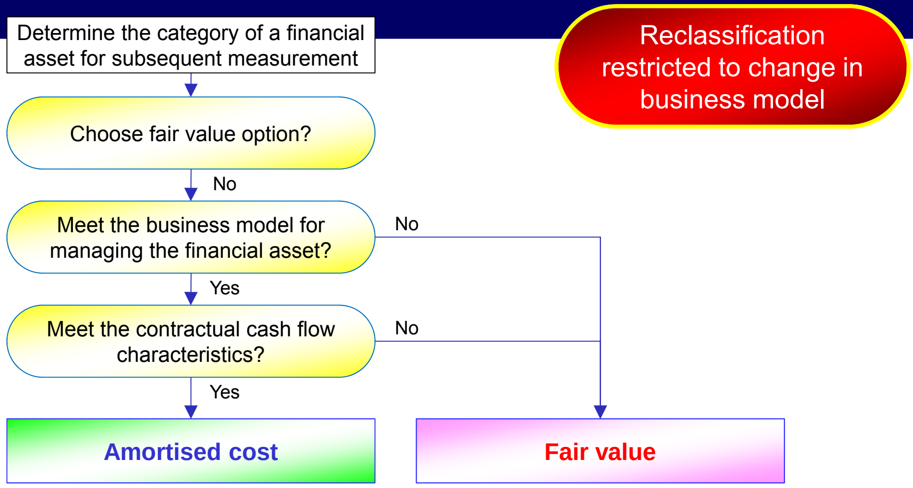
Reclassification under HKFRS 9



- 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. 4.1.1–4.1.4. (para. 4.4.1)

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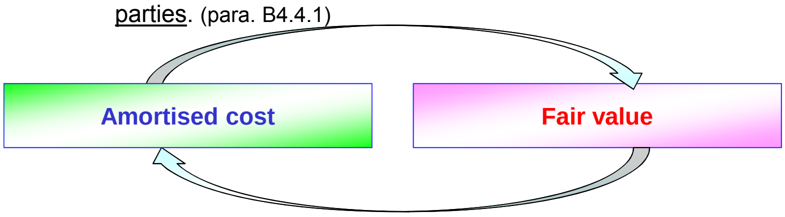
Reclassification under HKFRS 9

- HKFRS 9 requires an entity to reclassify financial assets if the objective of the entity's business model for managing those financial assets changes.
  - Such changes are expected to be very infrequent.
  - Such changes
    - must be determined by the entity's senior management as a result of external or internal changes and
    - must be significant to the entity's operations and demonstrable to external parties. (para. B4.4.1)



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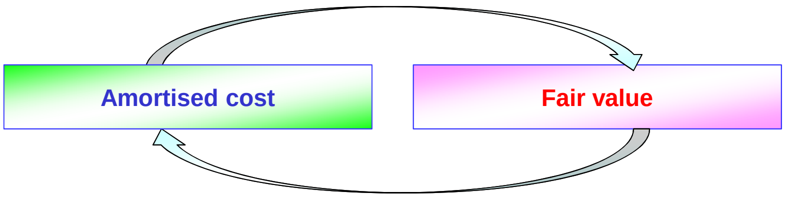
Reclassification under HKFRS 9

Reclassification of Financial Assets

- A change in the objective of the entity's business model must be effected before the reclassification date. (para. B4.4.2)
  - Reclassification date is defined as:
    - The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.



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Reclassification under HKFRS 9

Example

- If a financial services firm decides on 15 February to shut down its retail mortgage business and it has a reporting period ended on 31 March, what is the reclassification date?

- If a financial services firm decides on 15 February to shut down its retail mortgage business
  - The must reclassify all affected financial assets on 1 April (i.e. the first day of the entity's next reporting period),
  - The entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February. (para. B4.4.2)

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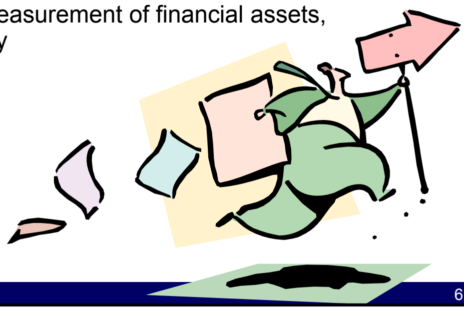
Today's Agenda

Measurement

- Subsequent measurement of financial assets, financial liability



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Subsequent Measurem

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 <u>fair values</u>, except for the following financial assets: — at fair value
  - Investments in equity instruments without fair value — at cost
  - Loans and receivables — at amortised cost
  - Held-to-maturity investments — at amortised cost

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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

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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**

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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

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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.

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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.

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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.

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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.

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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.

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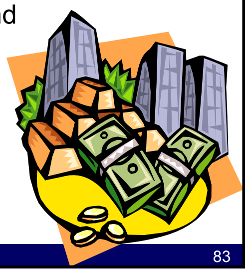
Impairment (for Amortised Cost)

- 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.

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.

Individual Assessment

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

Collective Assessment

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

Impairment (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).

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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.

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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.

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

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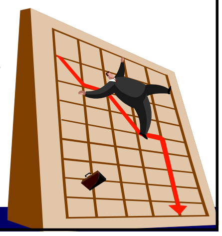
Impairment (for Amortised Cost)

- 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.



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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.

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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.

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Impairment (for Fair Value)

For Financial Assets Measured at Fair Value

- No impairment requirements

Based on HKFRS 9

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

Impairment under HKAS

Based on original HKAS 39

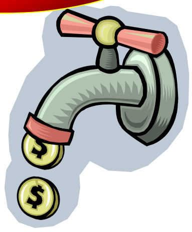
Available-for-Sale Financial Assets

- 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 39

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.

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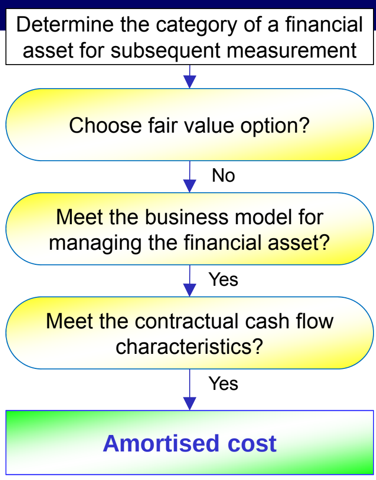
Gains and Losses under HKFRS 9



- 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. 5.7.2)

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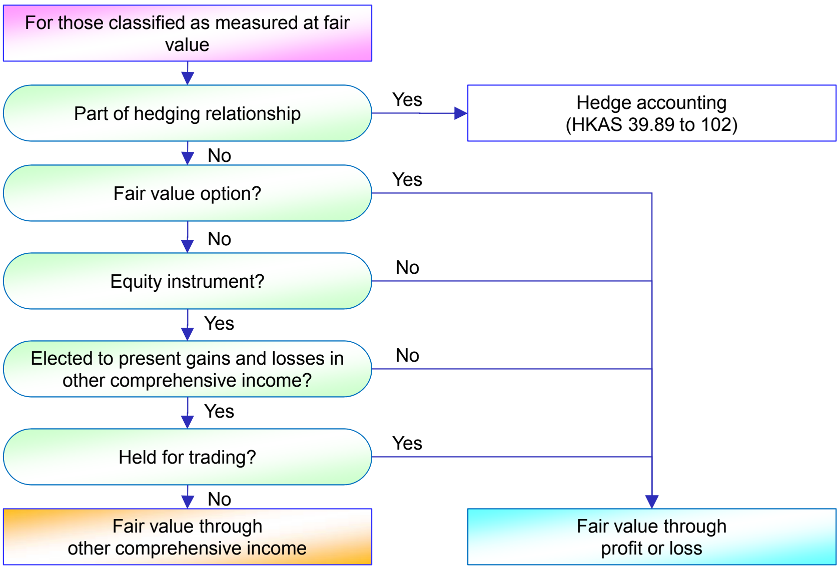
Gains and Losses under HKFRS 9



Gains and Losses under HKFRS 9

Equity instrument?

- All investments in equity instruments and contracts on those instruments must be measured at fair value.
- However, in limited circumstances, cost may be an appropriate estimate of fair value.
  - That may be the case
    - if insufficient more recent information is available to determine fair value, or
    - if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. (para. B5.4.14)

Gains and Losses under HKFRS 9

Example

- Indicators that cost might not be representative of fair value include:
  a. a significant change in the performance of the investee compared with budgets, plans or milestones.
  b. changes in expectation that the investee's technical product milestones will be achieved.
  c. a significant change in the market for the investee's equity or its products or potential products.
  d. a significant change in the global economy or the economic environment in which the investee operates.
  e. a significant change in the performance of comparable entities, or in the valuations implied by the overall market.
  f. internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.
  g. evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties. (para. B5.4.15)

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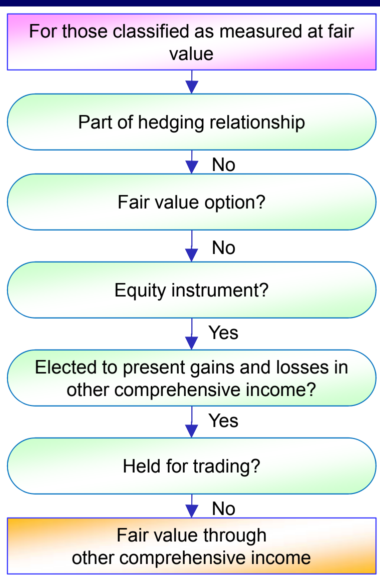
Gains and Losses under HKFRS 9



- A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognised in **profit or loss** unless
  a. It is part of a hedging relationship
  b. 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. 5.7.1)

Fair value through profit or loss

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Gains and Losses under HKFRS 9

- A gain or loss on financial assets or financial liabilities that are hedged items
  - shall be recognised in accordance with para. 89-102 of HKAS 39. (para. 5.7.3)

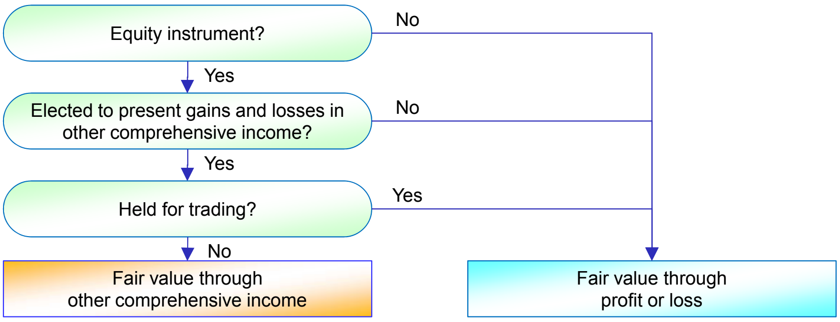
Same as before

Gains and Losses under HKFRS 9

- If an entity recognises financial assets using settlement date accounting,
  - For assets measured at amortised cost (other than impairment losses),
    - any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised
  - For assets measured at fair value, however,
    - the change in fair value shall be recognised in profit or loss or in other comprehensive income, as appropriate under para. 5.7.1. (para. 5.7.4)

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. 5.7.5)
- 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. 5.7.6)



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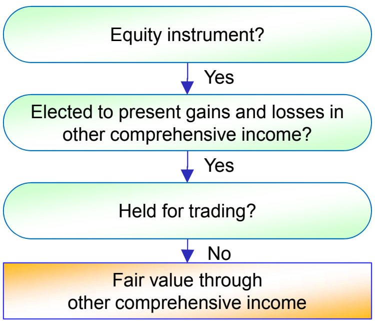
Gains and Losses under HKFRS 9



- Such irrevocable election (presenting fair value changes in other comprehensive income)
  - is made on an instrument-by-instrument (ie share-by-share) basis.
- Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss.
  - However, the entity may transfer the cumulative gain or loss within equity (e.g.. transfer between reserves).
- Dividends on such investments are recognised in profit or loss in accordance with HKAS 18 Revenue
  - unless the dividend clearly represents a recovery of part of the cost of the investment. (para. B5.7.1)

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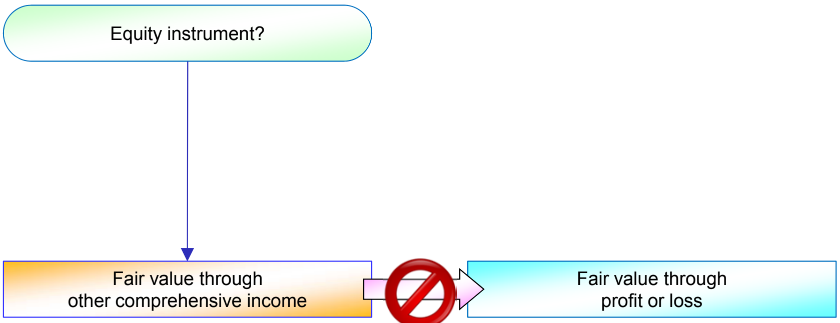
Gains and Losses under HKFRS 9

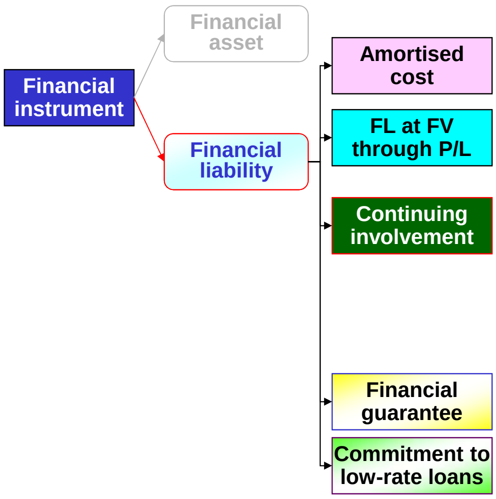
- Under HKFRS 9, amount presented in other comprehensive income shall not be subsequently transferred to profit or loss
  - Implies that
    - no recycling of any fair value change on those financial assets measured at fair value through other comprehensive income to profit or loss (or income statement)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



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 initially recognised at fair value and
  - o thereafter stated at amortised cost,
    - unless the effect of discounting would be immaterial, in which case they are stated at cost.

Classification of Financial Liability

Amortised cost

- Amortised cost
  - As those discussed in financial assets

FL at FV through P/L

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

Continuing involvement

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

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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.

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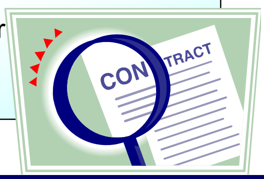
Classification of Financial Liability

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



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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.

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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*.

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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.

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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.

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Gains & Losses of F.L. under HKFRS 9

- An entity shall present a gain or loss on a financial liability designated as at fair value through profit or loss as follows:
  a. The amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability shall be presented in other comprehensive income (see para. B5.7.13–B5.7.20), and
  b. the remaining amount of change in the fair value of the liability shall be presented in profit or loss

  unless
  - the treatment of the effects of changes in the liability's credit risk described in (a) would create or enlarge an accounting mismatch in profit or loss (in which case paragraph 5.7.8 applies). (para. 5.7.7)

Financial liability → Credit risk

Other comprehensive income

Profit or loss

In that case, an entity shall present all gains or losses on that liability in profit or loss (para. 5.7.8)

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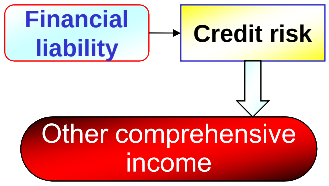
Gains & Losses of F.L. under HKFRS 9

- An entity determines the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability either:
  1. As amount of change in its fair value that is not attributable to the changes in market conditions that give rise to market risk, termed as "market condition method" or "residual method",
     - i.e. the residual amount after eliminating the changes attributable to the changes in market conditions (see Example); or
  2. Using an alternative method (or so-called independent valuation) the entity believes more faithfully represents the amount of change in the liability's fair value that is attributable to changes in its credit risk. (HKFRS 9.B5.7.16)



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Gains & Losses of F.L. under HKFRS 9

Example

- On 1 January 2011, Tim Singapore Inc. issues a 10-year bond with a par value of $150,000 and an annual fixed coupon rate of 8%, which is consistent with market rates for bonds with similar characteristics.
- Tim uses LIBOR as its observable benchmark interest rate.
  - At the date of inception of the bond, LIBOR is 5%.
  - At the end of the first year,
    - LIBOR has decreased to 4.75%
    - Fair value for the bond is $153,811, consistent with an interest rate of 7.6%.
- Tim assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.

Required:

- Using residual method to determine the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability.

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Gains & Losses of F.L. under HKFRS 9

Example

- Tim estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:
  1. Tim computes the liability's internal rate of return at the start of the period using the fair value of the liability and the liability's contractual cash flows at the start of the period.

     It deducts from this rate of return the observed benchmark interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.
     - At the start of the period of a 10-year bond with a coupon of 8%, the bond's internal rate of return is 8%.
     - Because the observed benchmark interest rate (LIBOR) is 5%, the instrument-specific component of the internal rate of return is 3%.

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Gains & Losses of F.L. under HKFRS 9

Example

2. Tim calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (1).
   - The contractual cash flows of the instrument at the end of the period are:
     - interest: $150,000 x 8% = $12,000 per year for each of years 2 to 10.
     - principal: $150,000 in year 10.
   - The discount rate to be used to calculate the present value of the bond is thus 7.75%, which is 4.75% (end of period LIBOR rate) plus 3% (instrument-specific component).
   - This gives a present value of $152,367

$$\frac{\$12{,}000}{(1+7.75\%)^1}+\frac{\$12{,}000}{(1+7.75\%)^2}+\ldots..+\frac{\$12{,}000}{(1+7.75\%)^3}+\frac{\$150{,}000}{(1+7.75\%)^9}=\$152{,}367$$

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Gains & Losses of F.L. under HKFRS 9

Example

3. The difference between the fair value of the liability at the end of the period and the amount determined in (2) is the change in fair value that is not attributable to changes in the observed benchmark interest rate. This is the amount relating to the effects of changes in the liability's credit risk to be presented in other comprehensive income.
   - The market price of the liability at the end of the period is $153,811.
   - The difference between the market price of the liability and the amount determined in (2), i.e. $153,811 - $152,367 = $1,444, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.

- In consequence, Tim presents $1,444, the effects of changes in the liability's credit risk, in other comprehensive income. (HKFRS 9.IE1-IE5)

Financial Instruments: Recap & Update
(Part 1)

7 September 2011

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Financial Instruments: Recap & Update
(Part 1)

7 September 2011

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