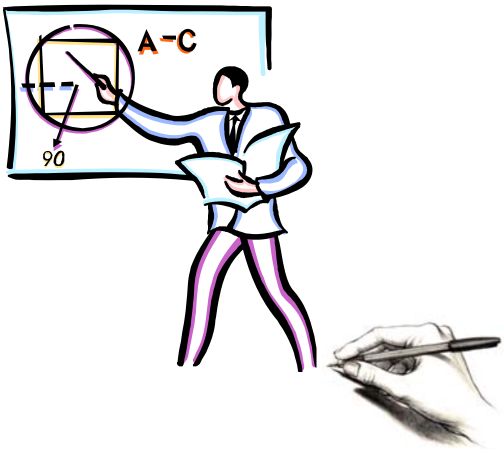
Annual Update on HKFRSs (IFRSs)

8 September 2007



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Today's Agenda

- Amendment Effective from 1 Jan. 2006
- Recap the implementation of HKAS 16, 17 and 40
- Recap the implementation of HKAS 39
- Amendment Effective after 1 Jan. 2006
- Potential development and amendments in 2007 to 2008

Simple but Comprehensive

Recap and key issues

Real Life Cases and Examples

Today’s Agenda

Amendment Effective from 1 Jan. 2006

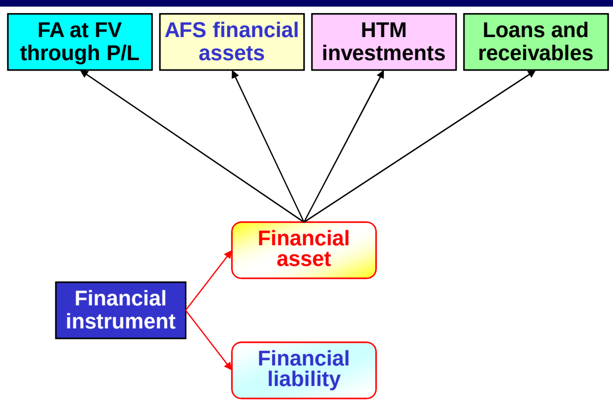
Amendment Effective from 1.1.2006

New interpretations and amendments to HKFRSs effective for periods beginning on/after 1 January 2006

- HKAS 19 Amendment *Employee Benefits – Actuarial Gains and Losses, Group Plans and Disclosures* (Apr. 2005)
- HKAS 21 Amendment *The Effects of Changes in Foreign Exchange Rates* (Jan. 2006)
- HKAS 39 Amendment *Cash Flow Hedge Accounting of Forecast Intragroup Transactions* (Jul. 2005)
- HKAS 39 Amendment *The Fair Value Option* (Jul. 2005)
- HKAS 39 and HKFRS 4 Amendments *Financial Guarantee Contracts* (Sep. 2005)
- HKFRS 6 *Exploration for and Evaluation of Mineral Resources* (Feb. 2005)
- HK(IFRIC) Interpretation 4 *Determining Whether an Arrangement Contains a Lease* (Feb. 2005)
- HK(IFRIC) Interpretation 5 *Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* (Feb. 2005)

The Fair Value Option (Amendment to HKAS 39)

Fair Value Option – Remember ……



4-category classification will <u>affect the subsequent measurement</u> of financial assets (but <u>not the initial measurement</u>).

Fair Value Option – Remember ……

FA at FV through P/L

Definition – for Financial Assets at Fair Value through P/L

A financial asset that meets either of the following 2 conditions.

a) It is classified as **held for trading**, if: **An entity has NO choice**

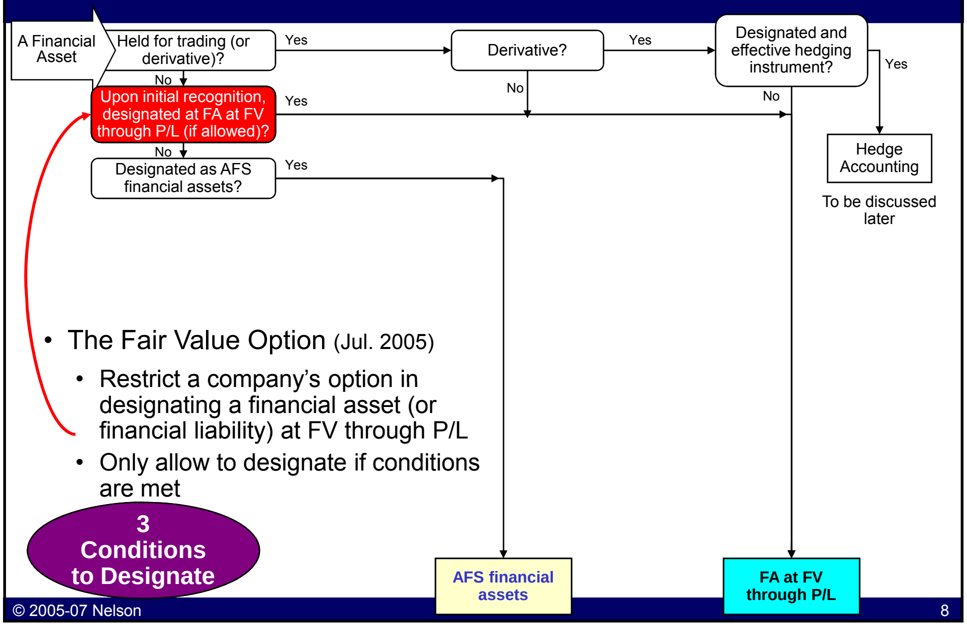
- i) it is acquired/incurred principally for the purpose of selling or repurchasing it in the near term;
- ii) there is evidence of a recent actual pattern of short-term profit-taking on it; or
- iii) a derivative
  (except for a designated and effective hedging instrument)

b) Upon **initial recognition** it is **designated** by the entity as at fair value through profit or loss, except for investments in equity instruments that **An entity has a choice**

- do not have a quoted market price in an active market, and
- whose fair value cannot be reliably measured.

But …… new requirements for 2006

Fair Value Option



- The Fair Value Option (Jul. 2005)
  - Restrict a company's option in designating a financial asset (or financial liability) at FV through P/L
  - Only allow to designate if conditions are met

3 Conditions to Designate

Fair Value Option

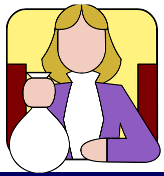
Upon initial recognition, an entity may designate a financial asset or financial liability as at fair value through profit or loss only:

- when permitted by paragraph 11A of HKAS 39, or
- when doing so results in more relevant information, because either
  - i) it eliminates or significantly reduces a measurement or recognition inconsistency
  - ii) financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis

1. Embedded Derivative Condition

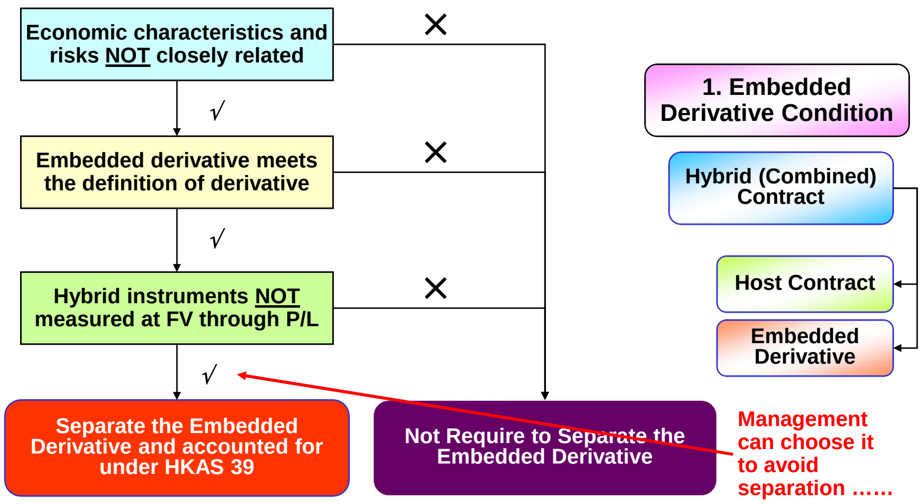
2. Eliminates Inconsistency

3. Managed on Fair Value Basis



3 Conditions to Designate

Fair Value Option



Fair Value Option

Paragraph 11A of HKAS 39

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

1. Embedded Derivative Condition

3 Conditions to Designate

Fair Value Option

- It eliminates or significantly reduces
  - a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from
    - measuring assets or liabilities or
    - recognising the gains and losses on them on different bases

2. Eliminates Inconsistency

3 Conditions to Designate

Fair Value Option

Example

- Entity A has a financial asset, say a portfolio of fixed income securities, would be classified as AFS financial asset
  - changes in fair value recognised in equity
- The portfolio is related to a financial liability, say a fixed rate bond, which is measured at amortised cost

2. Eliminates Inconsistency

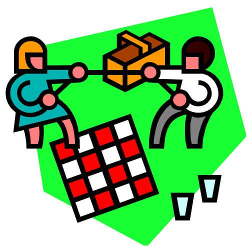
- In such circumstances, an entity may conclude that its financial statements would provide more relevant information
  - if both the asset and the liability were classified as at fair value through profit or loss

3 Conditions to Designate

Fair Value Option

- a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis,
  - in accordance with a documented risk management or investment strategy, and
  - information about the group is provided internally on that basis to the entity's key management personnel (as defined in HKAS 24)

    e.g. the entity's board of directors and chief executive officer.



3. Managed on Fair Value Basis

3 Conditions to Designate

Fair Value Option

Example

- The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value.
- HKAS 28 *Investments in Associates* and HKAS 31 *Interests in Joint Ventures*
  - allow such investments to be excluded from their scope provided they are measured at fair value through profit or loss.

3. Managed on Fair Value Basis

- An entity may apply the same accounting policy to other investments managed on a total return basis
  - but over which its influence is insufficient for them to be within the scope of HKAS 28 or HKAS 31.

3 Conditions to Designate

Fair Value Option

Example

- Entity A has financial assets and financial liabilities that share one or more risks and it
  - originates fixed interest rate loans and
  - manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.
- Those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management.

3. Managed on Fair Value Basis

- The circumstances show when the condition to designate could be met.

3 Conditions to Designate

Fair Value Option

Case

中国建设银行
China Construction Bank

Fair Value Through Profit and Loss (Annual Report 2006)

Financial assets and financial liabilities are designated at fair value through profit or loss upon initial recognition when:

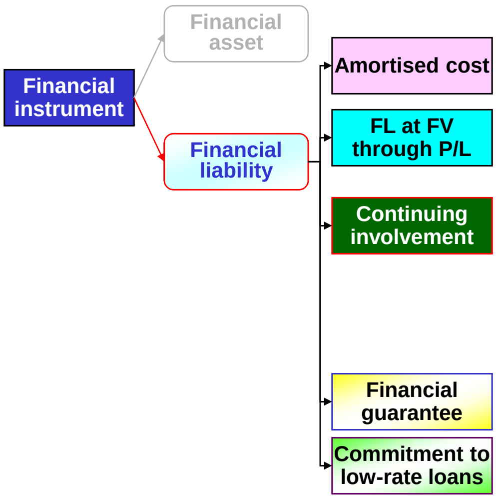
- the financial assets or financial liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise;
- the financial asset or financial liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract; or
- the separation of the embedded derivatives from the financial instrument is prohibited.

All derivatives not qualified for hedging purposes are included in this category and are carried as assets when their fair value is positive and as liabilities when their fair value is negative.

Financial Guarantee Contracts

(Amendment to HKAS 39 and HKFRS 4)

Financial Guarantee Contracts



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.

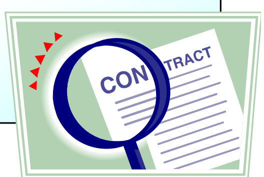
Financial Liabilities – Measurement

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



Financial Liabilities – Measurement

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.

Financial Liabilities – Measurement

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*.

Financial Liabilities – Measurement

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.

Financial Liabilities – Measurement

Financial guarantee

Asserted Explicitly

Used Insurance Accounting

Assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's
- communications with customers and regulators,
- contracts,
- business documentation and
- financial statements.

- KPMG (FRU Issue 28, Jan. 2006):
  - ➢ This election applies to previously existing contracts as well as to similar contracts that an entity may enter into in the future.
- Ernst & Young (Sep. 2005):
  - ➢ The amendment applies to all existing contracts and any new contracts issued by an entity.

Financial Liabilities – Measurement

Financial guarantee

Asserted Explicitly

Used Insurance Accounting

- KPMG Singapore (Aug. 2006):
  - If a guarantee arrangement is accounted for under FRS 104 (which is based on IFRS 4 without modification) by a non-insurance entity,
    - the guarantee arrangement should be disclosed as a contingent liability.
  - A liability is only recognised
    - if payment become probable.
  - This treatment is consistent with the current position in accounting for financial guarantees by non insurance entities.

Financial Liabilities – Measurement

Case

Financial guarantee

Jardine Matheson

- 2006 Annual Report
  - Financial guarantee contracts under which the Group accepts significant risk from a third party by agreeing to compensate that party on the occurrence of a specified uncertain future event
    - are accounted for in a manner similar to insurance contracts.
  - Provisions are recognized when
    - it is probable that the Group has obligations under such guarantees and
    - an outflow of resources embodying economic benefits will be required to settle the obligations.

Financial Liabilities – Measurement

Case

Financial guarantee

Tristate Holdings Limited

- 2006 Annual Report
  - For guarantees provided by the Company for banking facilities granted to subsidiaries, the Company
    - regards such guarantees as insurance contracts and does not recognise liabilities for financial guarantees at inception,
    - but performs a liability adequacy test at each reporting date and recognise any deficiency in the liabilities in the income statement.

Financial Liabilities – Measurement

Financial guarantee

- HKFRS 4 *Insurance Contracts*:

  Liability adequacy test (HKFRS 4.15)
  - An insurer shall assess at each reporting date whether its recognised insurance liabilities are adequate,
    - using current estimates of future cash flows under its insurance contracts.
  - If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32) is inadequate in the light of the estimated future cash flows,
    - the entire deficiency shall be recognised in profit or loss.

Financial Liabilities – Measurement

Case

香港交易所 HKEx

- Early adopted Financial Guarantee Contracts in 2005 and its annual report stated that (extract only):
  - A financial guarantee contract is a contract that requires the Group to make specified payments to reimburse the holder for a loss it incurs because a specified entity or person fails to make payment when due in accordance with the original or modified terms of a debt instrument.
  - Financial guarantee contracts are accounted for as financial instruments under HKAS 39 and are <u>initially recognised at fair value</u>.
  - Subsequently, such contracts are measured at the higher of
    - the amount determined in accordance with HKAS 37 – Provisions, Contingent Liabilities and Contingent Assets and
    - the amount initially recognised less, where appropriate, cumulative amortisation recognised over the life of the guarantee on a straight-line basis.

Financial Liabilities – Measurement

Case

香港交易所 HKEx

- How did HKEx calculate <u>the fair value</u> of the financial guarantee?

  Its annual report (2005) stated that:
  - The fair values are based on the fees charged by financial institutions for granting such guarantees discounted using a ten-year Hong Kong Government bond rate to perpetuity.

  Its financial statements (2006) issued 8 Mar. 2007 had the above explanation and further stated that:
  - The discount rate was 3.73 per cent as at 31 December 2006 (2005: 4.18 per cent).

Financial Liabilities – Measurement

Case

Goldbond Group Holdings Ltd. – Interim Report 2006/07:

Note 16: Financial guarantee contracts

- In July 2004, the Group granted a guarantee of US$3,750,000, equivalent to approximately HK$29,250,000 in respect of banking facilities granted to a jointly controlled entity.
- In May 2005, the Group entered into funding, allocation and distribution agreements in respect of a bank loan of RMB148,977,000, equivalent to approximately HK$146,056,000 borrowed by a jointly controlled entity. Pursuant to such agreements, the Group has taken on the funding undertaking and buy-back undertakings, details of which were set out in the Company's circular dated 14 June 2005.
- At the respective date of grant, the fair value of the financial guarantee contracts was assessed by external valuers, Vigers Appraisal & Consulting Limited amounted to US$137,000 (equivalent to approximately HK$1,069,000) and RMB762,000 (equivalent to approximately HK$733,000) respectively.

Financial Liabilities – Measurement

Case

Annual Report 2006 – Note 3.20 clarified that

- A financial guarantee contract is
  - a contract that requires the issuer (or guarantor) 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 terms of a debt instrument.
- Where the Group issues a financial guarantee, the fair value of the guarantee is initially recognised as deferred income within trade and other payables.
  - Where consideration is received or receivable for the issuance of the guarantee, the consideration is recognised in accordance with the Group's policies applicable to that category of asset.
  - Where no such consideration is received or receivable, an immediate expense is recognised in income statement on initial recognition of any deferred income.

Dr Cash/Assets
Cr Payables

Dr Profit & loss
Cr Payables

Financial Liabilities – Measurement

Case

Recruit 才庫媒體集團有限公司

Annual Report 2006 – Note 3.20 clarified that

- The amount of the guarantee initially recognised as deferred income
  - is amortised in income statement over the term of the guarantee as income from financial guarantees issued.
- In addition, provisions are recognised if and when
  - it becomes probable that the holder of the guarantee will call upon the Group under the guarantee and
  - the amount of that claim on the Group is expected to exceed the current carrying amount, i.e. the amount initially recognised less accumulated amortisation, where appropriate.

Dr Payables
Cr Profit & loss

Dr Profit & loss
Cr Payables

Financial Liabilities – Measurement

Case

Recruit 才庫媒體集團有限公司

How much did it have …….

Annual Report 2006 – Note 36 set out:

	Group 2006 HK$'000	Group 2005 HK$'000	Company 2006 HK$'000	Company 2005 HK$'000
Corporate guarantees given and utilised*	–	–	**14,000**	16,000

* As at 31 December 2006, the Company has given corporate guarantees to its non wholly owned subsidiary to the extent of HK$24,700,000 (2005: HK$33,060,000) in relation to payments for certain finance leases to financial institutions as set out in Note 27 to the financial statements, HK$14,000,000 (2005: HK$16,000,000) of which was utilised.

Most critical ….. "In the opinion of the directors of the Company,

– no material liabilities will arise from the above guarantees which arose in the ordinary course of business and

– the fair value of the corporate guarantees granted by the Company is immaterial.

Financial Liabilities – Measurement

Case

中國海外發展有限公司
CHINA OVERSEAS LAND & INVESTMENT LTD.

Note 51 "Contingent Liabilities" of 2006 Annual Report states that :

a) Guarantees given and indemnities provided by the Group and the Company in respect of credit facilities granted to …….

- Other than the guarantee provided by the Company as mentioned in item (a), the directors considered that the fair values of these financial guarantee contracts at their initial recognition are insignificant on the basis of short maturity periods and low applicable default rates.
- The financial guarantee contracts of the Company have been recognised in the Company's financial statements.

Financial Liabilities – Measurement

Case

KPMG

The Illustrative Financial Statements for 2006

Note 37(c) states that:

- As at the balance sheet date, the directors do not consider it probable that a claim will be made against the company under any of the guarantees ……
- Deferred income in respect of the single guarantees issued is disclosed in note 26.
- The company has not recognised any deferred income in respect of the cross guarantee as its fair value cannot be reliably measured and its transaction price was $Nil.

Financial Liabilities – Measurement

Case

Suncorp Technologies Limited – 2006 Annual Report:

Note 3:

- In relation to financial guarantees granted to certain banks over the repayment of loans by a jointly controlled entity, the Group has applied the transitional provisions of HKAS 39.
- The fair value of the financial guarantee contracts at the date of grant was approximately HK$3.4 million.
- It represents a deemed capital contribution to the jointly controlled entity and has been included in the cost of investment in the jointly controlled entity.

Note 26

- In September 2006, the Group has given financial guarantees to two banks in respect of the credit facilities of HK$56,634,000 granted to a jointly controlled entity for a period of 10 months.
- The directors have assessed the fair value at the date of granting the financial guarantees to be approximately HK$3,354,000 and the amount is amortised to the consolidated income statement over the period of the facilities granted.

HK(IFRIC) Interpretations 4

Determining Whether an Arrangement Contains a Lease

Background and Scope

- An entity may enter into an arrangement (comprising a transaction or a series of related transactions) that
  - does not take the legal form of a lease
  - but conveys a right to use an asset in return for a payment or series of payments.

Right to use an asset + **Services**

- HK(IFRIC) Interpretation 4
  - provides guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with HKAS 17

Background and Scope

Example

Examples of arrangements in which one entity (the supplier) may convey such a right to use an asset to another entity (the purchaser), often together with related services, include:

Right to use an asset + **Services**

1. **outsourcing arrangements**
   e.g. the outsourcing of the data processing functions of an entity (IT system plus support services)
2. **arrangements in the telecommunications industry**
   in which suppliers of network capacity enter into contracts to provide purchasers with rights to capacity (telecommunication facilities plus services)
3. **take-or-pay and similar contracts**
   in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services
   e.g. a take-or-pay contract to acquire substantially all of the output of a supplier's power generator (power generator plus related services)

Issues

How to Determine

When to Determine

How to Separate

Right to use an asset + Services

The issues addressed in HK(IFRIC) Interpretation 4 are:

a) how to determine whether an arrangement is, or contains, a lease as defined in HKAS 17;

b) when the assessment or a reassessment of whether an arrangement is, or contains, a lease should be made; and

c) if an arrangement is, or contains, a lease, how the payments for the lease should be separated from payments for any other elements in the arrangement.

Conclusions

How to Separate

If an arrangement contains a lease

- the parties to the arrangement shall apply the requirements of HKAS 17 to the lease element of the arrangement,
  - unless exempted from those requirements in accordance with HKAS 17.
- that lease shall be classified as
  - a finance lease, or
  - an operating lease

  in accordance with HKAS 17.

Right to use an asset + Services

Other elements of the arrangement not within the scope of HKAS 17 shall be accounted for in accordance with other standards.

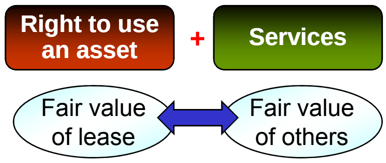
Conclusions

How to Separate

For the purpose of applying the requirements of HKAS 17,

- payments and other consideration required by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into
  - those for the lease, and
  - those for other elements

  on the basis of <u>their relative fair values</u>.



The minimum lease payments as defined in HKAS 17

- <u>include</u> only payments for the lease (i.e. the right to use the asset) and
- <u>exclude</u> payments for other elements in the arrangement (e.g. for services and the cost of inputs).

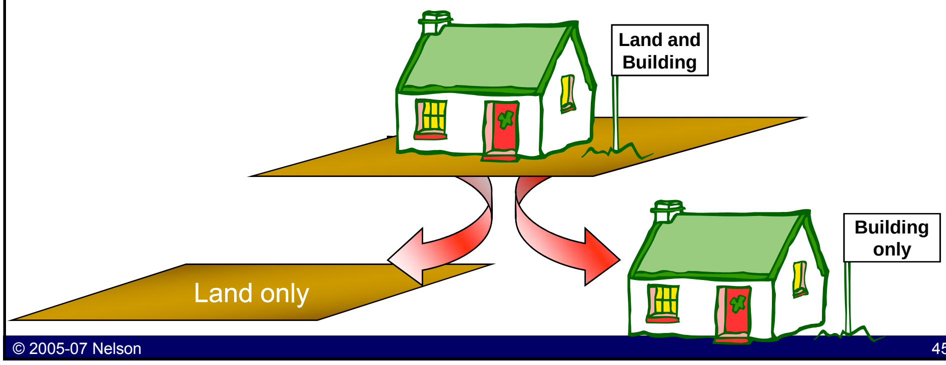
Today's Agenda

Recap the implementation of HKAS 16, 17 and 40

HKAS 17 Leases

- New requirements with significant impact, mainly ……

Separate measurement
(of the land and buildings elements) at the inception of the lease



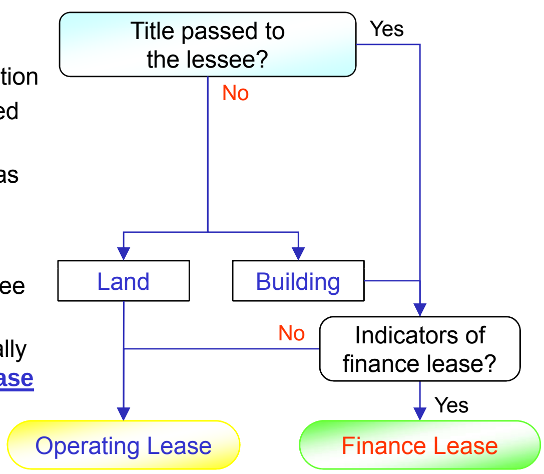
Leases – Separate Measurement

If a lease contains land and buildings elements
- 2 elements are considered separately for lease classification

If **title** of both elements is expected to pass to the lessee
- Both elements are classified as **finance lease**

If **title** of land or both elements is NOT expected to pass to the lessee
- The land element alone (as having indefinite life) is normally classified as an **operating lease**
- The building element is considered separately

Lease of land and buildings



Leases – Separate Measurement

Lease of land and buildings

- To classify and account for a lease of land and buildings
  - the minimum lease payments (including any lump-sum upfront payments) are allocated between
    - the land and
    - the buildings elements
  - in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease

Relative Fair Value

Land only

Building only

Leases – Separate Measurement

Lease of land and buildings

Minimum lease payment allocated in proportion to the **relative fair values** of land and building elements

Title passed to the lessee?
Yes
No
Can lease payments be reliably allocated into land and building elements?
No
Yes
Land
Building
No
Indicators of finance lease?
Yes
Operating Lease
Finance Lease

Leases – Separate Measurement

Lease of land and buildings

- If the lease payments <u>cannot be allocated</u> reliably between the 2 elements
  - the entire lease is classified as a **finance lease**
  - unless it is clear that both elements are operating leases, in which case the entire lease is classified as an **operating lease**
- For a lease of land and building if the land is immaterial
  - The lease may be treated as a single unit and classified as finance or operating leases

Land only

Building only

Leases – Separate Measurement

Case

中国银行(香港)
BANK OF CHINA (HONG KONG)

Accounting policy on finance lease on properties (annual report 2005):

- On adoption of <u>the deemed cost at the date of Merger</u> (2001), the Group made reference to the independent property valuation conducted as at 31 Aug. 2001 for the purpose of the Merger, which <u>did not split</u> the values of the leasehold properties between the land and buildings elements.
- Any means of <u>subsequent allocation</u> of the valuation of the leasehold properties at the date of Merger between the land and buildings elements would be notional and therefore <u>would not represent reliable information</u>.
- It is determined that the values of the land and buildings elements of the Group's leasehold properties <u>cannot be reliably split</u> and the leasehold properties are <u>treated as finance leases</u>.
- The Group has also adopted the revaluation model under HKAS 16 by which assets held for own use arising under these finance leases are measured at fair value less any accumulated depreciation and impairment losses.

HKAS 40 Investment Property

- Amended and clearer definition on an investment property

HKAS 40

Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

a) use in the production or supply of goods or services or for administrative purposes; or

b) sale in the ordinary course of business

How's about property held by the lessee under an operating lease?

Definitions – Extend to Operating Leases

- A property interest
  - that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if
    - the property would otherwise meet the definition of an investment property and
    - the lessee uses the Fair Value Model

An entity has a choice

- This classification alternative is available on a property-by-property basis
- However, once this classification alternative is selected for one such property interest held under an operating lease, all properties classified as investment property shall be accounted for using the Fair Value Model

Simple?

Let's term this classification as
"Operating Lease IP Alternative"

Measurement after Recognition

Introduce Cost Model and choose either **Fair Value Model** and **Cost Model**

- HKAS 40 implicitly implies that the choice can only be elected on the first-time adoption of HKAS 40
- The model chosen should be applied to all investment properties, except for some identified exceptions.
- However, even Cost Model is adopted, HKAS 40 still requires all entities to determine the fair value of investment property ……
  - For disclosure purpose, the fair value of the investment property has to be disclosed in notes to the financial statement!
  - In determining the fair value of investment property for both cost model and fair value model

    ⇒ an entity is only encouraged, but not required, to rely on a professional valuer's valuation

Measurement after Recognition

After initial recognition, an entity that chooses → **Fair Value Model**

- shall measure all of its investment property at fair value, except in some limited cases.
  - When a property interest held by a lessee under an operating lease is classified as an investment property

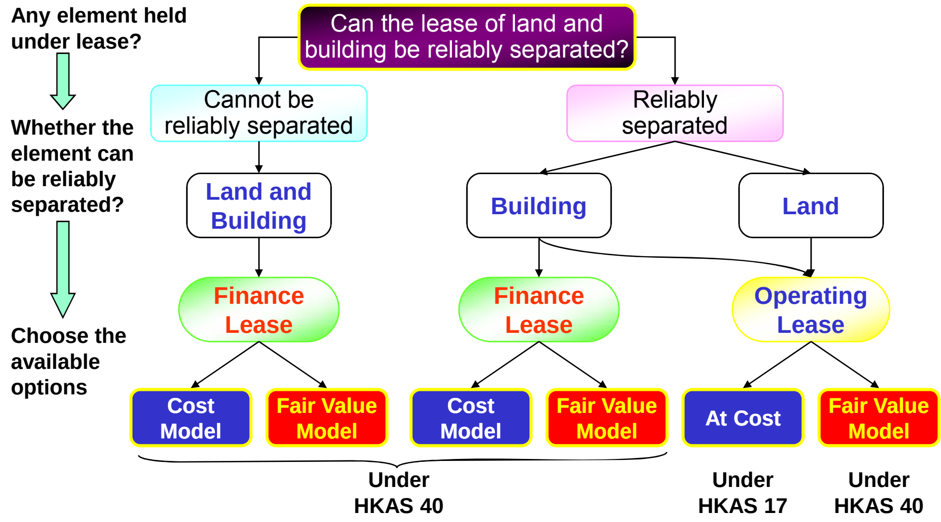
    ⇒ the fair value model must be applied for all investment properties
  - A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises
  - The fair value of investment property shall reflect market conditions at the balance sheet date

No depreciation required in HKAS 40

Depreciation?
Tax Implication?

Not our concern this time!
But be careful, good & bad ……

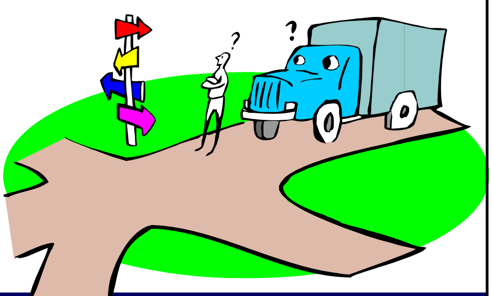
Application of HKAS 17 & 40 in HK



Application of HKAS 17 & 40 in HK

Example

- Can PPE or Investment Property in HK or PRC be carried at cost model after the adoption of HKAS 17 and HKAS 40?



Application of HKAS 17 & 40 in HK

Example

- Can PPE or Investment Property in HK or PRC be carried at cost model after the adoption of HKAS 17 and HKAS 40?

- PPE can be carried at cost model if either:
  - The lease of land and building cannot be reliably allocated between land and building element
    - The whole lease will be
      - classified as finance lease (other than exception case) and
      - then accounted for at cost model under HKAS 16; or
  - The lease of land and building can be reliably allocated between land and building
    - The land is carried at amortised cost under HKAS 17
    - The building is carried at cost model under HKAS 16

Application of HKAS 17 & 40 in HK

Example

- Can PPE or Investment Property in HK or PRC be carried at cost model after the adoption of HKAS 17 and HKAS 40?

- Investment Property can be carried at cost model if either:
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    - The whole lease will be
      - classified as finance lease (other than exception case) and
      - then accounted for at cost model under HKAS 40; or
  - The lease of land and building can be reliably allocated between land and building
    - The land is carried at amortised cost under HKAS 17
    - The building is carried at cost model under HKAS 40

Application of HKAS 17 & 40 in HK

Case

交通銀行 BANK OF COMMUNICATIONS

Accounting policy on land use right (annual report 2005):

- Land use rights are recognised initially at 'cost',
  - being the consideration paid for the rights to use and occupy the land.
- Land use rights are amortised
  - using the straight-line method to write off the cost over their estimated useful lives of 30 to 70 years.
- Land use rights are not separately presented from building, when
  - they are acquired together with the building at inception and
  - the costs attributable to the land use rights cannot be reasonably measured and separated from that of the building.

Application of HKAS 17 & 40 in HK

Case

方正控股有限公司 Founder Holdings Limited 方正集团

Annual Report 2005

- In the opinion of the directors, the lease payments of the Group cannot be allocated reliably between the land and building elements, therefore, the entire lease payments are included in the cost of land and building and are amortised over the shorter of the lease terms and useful lives.

taifook大福 securities group 證券集團

Annual Report 2005

- As the Group's lease payments cannot be allocated reliably between the land and buildings elements, the entire lease payments are included in the cost of the land and buildings as a finance lease in property, plant and equipment.
- The adoption of HKAS 17 has not resulted in any change in the measurement of the Group's land and buildings.

Today's Agenda

Recap the implementation of HKAS 39

Summary of Changes

Scope	• Extended the scope to all contract to buy and sell of non-financial items that meet the scope.
Definitions	• Financial instruments, including derivatives, are clearly defined.
Initial Recognition	• All financial instruments, including derivatives, are recognised in the balance sheet (on balance sheet).
Measurement	• Except for strict conditions are fulfilled, all financial assets are measured at fair value

Initial Recognition

Scope

Definitions

Initial Recognition

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

Initial Recognition

Financial instrument → **Financial asset** / **Financial liability** → Initial Recognition: **Trade Date Accounting** | **Regular Way of purchase or sale**

- An entity shall recognise financial instruments on its balance sheet when and only when the entity <u>becomes a party to the contractual provisions</u> of the instruments
  - Implies **trade date accounting** for all cases
  - Only **a regular way purchase or sale** (e.g. purchase of derivatives is not a regular way of purchase) can be accounted for by
    - either **trade date accounting** or **settlement date accounting**

Initial Recognition & Measurement

Financial instrument → **Financial asset** / **Financial liability** → Initial Recognition: **Trade Date Accounting** | **Regular Way of purchase or sale**

↓

Initial Measurement: **Fair Value** + **Transaction Cost**

- When a financial asset or financial liability is recognised initially, an entity shall measure the **financial asset** or a **financial liability**
  - at its ***fair value***
  - plus transaction costs (except for those classified *at fair value through profit or loss*)

Initial Recognition & Measurement

Example

Fair value at Initial Recognition – Low Interest Loan

- Entity A grants a 3-year loan of HK$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 HK$50,000 to a customer in order to guarantee that it would complete the service contract in 5 years' time.
- When the contract completes (say after 5 years), the deposit would be refunded in full without any interest.

Initial Recognition & Measurement

Initial Measurement (HKAS 39.AG64)

- The **fair value** of a financial instrument on **initial recognition is normally the transaction price** (i.e. the fair value of the consideration given or received).
- However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique.
  - For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as
    - the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating.
  - Any additional amount lent is an expense or a reduction of income
    - unless it qualifies for recognition as some other type of asset.

Initial Recognition & Measurement

Case

HSBC

Determination of Fair Value (Annual Report 2006)

All financial instruments are recognised initially at fair value.

- 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.

In certain circumstances, however, the initial fair value may be based

- on other observable current market transactions in the same instrument, without modification or repackaging, or
- on a valuation technique whose variables include only data from observable markets.

Initial Recognition & Measurement

Case

Accounting report 2006

Held-to-maturity financial assets

Held-to-maturity financial assets are non-derivative financial assets that comprise fixed or determinable payments and maturities of which the Group has the positive intention and ability to hold until maturity.

Investments intended to be held for an undefined period are not included in this classification.

These investments are initially recognized at cost, being the fair value of the consideration paid for the acquisition of the investment.

All transaction costs directly attributable to the acquisition are also included in the cost of the investment.

Initial Recognition & Measurement

Example

Fair value at Initial Recognition

- Entity A grants a loan of HK$50,000 to a related party, B, on 1 Jan. 2005 as one kind of financial assistance to support B's operation.
  - A expects the return on B's future operation would be higher.
  - However, A has not specified the interest rate and repayment terms with Entity B.
  - A charges another related party at a current market lending rate of 6%
- Discuss the implication of the loan.

Initial Recognition & Measurement

No Active Market: Valuation Technique (HKAS 39.AG79)

- Short-term receivables and payables with no stated interest rate may be measured
  - at the original invoice amount if the effect of discounting is immaterial.

- Implies, no matter it is receivable from related party, or interest-free
  - No discounting may be required
  - Effective interest estimates (imputed interest) may be required
- Can management argue it is "repayable on demand", even they expect that it would not be repaid soon?
  - Is it an estimate or judgement issue?

Initial Recognition & Measurement

Any other ways?

- HKAS 39.2 states "This Standard shall be applied by all entities to all types of financial instruments except:
  a) those interests in subsidiaries, associates and joint ventures that are accounted for under HKAS 27 *Consolidated and Separate Financial Statements*, HKAS 28 *Investments in Associates* or HKAS 31 *Interests in Joint Ventures* ……
- HKAS 21.15 states "An entity may have a monetary item that is receivable from or payable to a foreign operation.
  - An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, **a part of the entity's net investment** in that foreign operation …….
  - Such monetary items may include long-term receivables or loans.
  - They do not include trade receivables or trade payables.

Applied to foreign operation only?

Fair Value and Financial Liabilities

Another latest observations on financial liabilities ……

- A liability shall be classified as **current** when it satisfies any of the following criteria:
  a) it is expected to be settled in the entity's normal operating cycle;
  b) it is held primarily for the purpose of being traded;
  c) it is due to be settled within 12 months after the balance sheet date; or
  d) the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

- All other liabilities shall be classified as **non-current**.

Fair Value and Financial Liabilities

Any implication on loans from shareholders or other similar parties?

Any implication on fair value or valuation techniques?

Another latest observations on finan

- A liability shall be classified as **current** w
  following criteria:
  a) it is expected to be settled in
  b) it is held primarily for the purp
  c) it is due to be settled within 12 mon
  date; or
  d) the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

  New requirements

- All other liabilities shall be classified as **non-current**.

Measurement after Recognition

Scope

Definitions

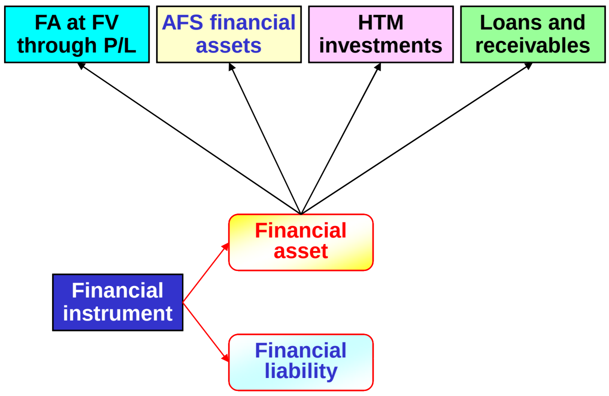
Initial Recognition

Measurement

- Except for strict conditions are fulfilled, all financial assets are measured at fair value

4-category classification will <u>affect the subsequent measurement</u> of financial assets (but <u>not the initial measurement</u>).

Measurement – Classification



4-category classification will <u>affect the subsequent measurement</u> of financial assets (but <u>not the initial measurement</u>).

Measurement after Recognition

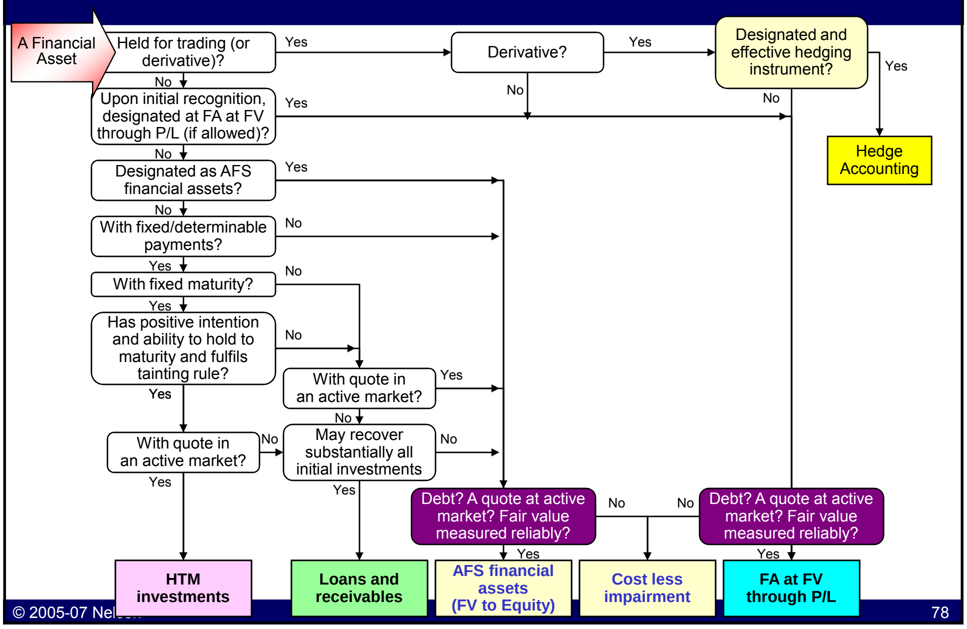
Classification determine
Subsequent Measurement

FA at FV through P/L	at Fair Value To P/L	
AFS financial assets	at Fair Value To Equity at Cost	Except for • investments in equity instruments that • do not have a quoted market price in an active market, and • whose fair value cannot be reliably measured
HTM investments	at Amortised Cost	
Loans and receivables	at Amortised Cost	

Amortised cost of a financial instrument is:

- 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**, and
- minus any reduction for impairment or uncollectibility.

Measurement after Recognition



Measurement – Impairment

Subsequent Measurement | **Impairment**

	Subsequent Measurement
FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value at Cost
HTM investments	at Amortised Cost
Loans and receivables	at Amortised Cost

Impairment

At each balance sheet date

- assess whether there is any objective evidence that a financial asset (or group of financial assets) is impaired.
- Conditions must be fulfilled in recognising impairment loss.

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

FA at FV through P/L — at Fair Value →

- Implicitly, no impairment review is needed as gain or loss on change in fair value is recognised in profit or loss

AFS financial assets — at Fair Value →

- 2 conditions to effect impairment loss
  1. when a decline in its fair value has been recognised directly in equity and
  2. there is objective evidence that it is impaired
- Then, the cumulative loss recognised directly in equity shall be
  - removed from equity and
  - recognised in profit or loss

  even the asset has not been derecognised.

AFS financial assets — at Cost →

- Impairment loss is measured as the difference between
  - the carrying amount of the financial asset, and
  - the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

HTM investments

Loans and receivables

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value / at Cost
HTM investments	**at Amortised Cost** ➡
Loans and receivables	**at Amortised Cost** ➡

- The amount of 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)
- The carrying amount of the asset shall be reduced either
  - directly or
  - through use of an allowance account.
- The amount of the loss shall be recognised in profit or loss.

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value / at Cost
HTM investments	**at Amortised Cost** ➡
Loans and receivables	**at Amortised Cost** ➡

Implication?

Sequence of Impairment Assessment

- First assesses whether objective evidence of impairment exists
  - individually for financial assets that are individually significant, and
  - individually or collectively for financial assets that are not individually significant.
- If 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.
- Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

Measurement – Summary

	Subsequent Measurement	Impairment	Reversal	Reclassification
FA at FV through P/L	at Fair Value to P/L	Not required	N/A	Not allowed
AFS financial assets	at Fair Value to Equity at Cost	From Equity to P/L To P/L	Related objectively to an event for debt instrument only	To HTM or AFS at Cost To AFS at Fair Value
HTM investments	at Amortised Cost	To P/L	Related objectively to an event	To AFS
Loans and receivables	at Amortised Cost	To P/L	Related objectively to an event	Not described in HKAS 39; implicitly, not feasible

Today's Agenda

Amendment Effective after 1 Jan. 2006

Amendment Effective After 1.1.2006

Selected new interpretations and amendments to HKFRSs issued in 2005 and 2006	Effective for periods beginning on/after
• HK(IFRIC) Interpretation 7 *Applying the Restatement Approach under HKAS 29 Financial Reporting in Hyperinflationary Economies* (Jan. 2006)	➢ 1 Mar. 2006
• HK(IFRIC) Interpretation 8 *Scope of HKFRS 2* (May 2006)	➢ 1 May 2006
• HK(IFRIC)-Int. 9 *Reassessment of Embedded Derivatives* (May 2006)	➢ 1 Jun. 2006
• HK(IFRIC)-Int. 10 *Interim Financial Reporting and Impairment* (Sep. 2006)	➢ 1 Nov. 2006
• HK(IFRIC)-Int. 11 *HKFRS 2 — Group and Treasury Share Transactions* (Jan. 2007)	➢ 1 Mar. 2007
• HK(IFRIC)-Int. 12 *Service Concession Arrangements* (Mar. 2007)	➢ 1 Jan. 2008
• HKAS 1 Amendment *Capital Disclosures* (Sep. 2005)	➢ 1 Jan. 2007
• HKFRS 7 *Financial Instruments: Disclosures* (Sep. 2005)	➢ 1 Jan. 2007
• HKFRS 8 *Operating Segments* (Mar. 2007)	➢ 1 Jan. 2009

Service Concession Arrangements

(HK(IFRIC) Interpretation 12)

Background

- An arrangement within the scope of this Interpretation, "Service Concession Arrangements", typically involves
  - a private sector entity (an operator)
    - constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and
    - operating and maintaining that infrastructure for a specified period of time.
- The operator is paid for its services over the period of the arrangement.
  - The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes.
- Such an arrangement is often described as
  - a "build-operate-transfer" (BOT),
  - a "rehabilitate-operate-transfer" (ROT) or
  - a "public-to-private" service concession arrangement.

Issues

- The interpretation sets out general principles on recognising and measuring the obligations (liabilities) and related rights (assets) in service concession arrangements for the operators
- Requirements for disclosing information about service concession arrangements are in HK(SIC)-Int. 29 *Service Concession Arrangements: Disclosures*.
- The issues addressed in the interpretation are:
  a) Treatment of operator's rights over the infrastructure;
  b) Recognition and measurement of arrangement consideration;
  c) Construction or upgrade services;
  d) Operation services;
  e) Borrowing costs;
  f) Subsequent accounting treatment of a financial asset and an intangible asset; and
  g) Items provided to the operator by the grantor.

Summary of HK(IFRIC)-Int 12

a) Treatment of operator's rights over the infrastructure;
b) Recognition & measurement of arrangement consideration;
c) Construction or upgrade services;
d) Operation services;
e) Borrowing costs;
f) Subsequent accounting treatment of a financial asset and an intangible asset; and
g) Items provided to the operator by the grantor.

Shall not be recognised as PPE

FV to be used

Construction or Upgrade Services

Operation Services

⇨ HKAS 11

⇨ HKAS 18

⇨ HKAS 23

Financial Asset
HKAS 39
Unconditional contractual right to receive cash or other FA

Intangible Asset
HKAS 38
A right (a licence) to charge users

Use only or as part of the consideration

Summary of HK(IFRIC)-Int 12

Case

China Everbright International Limited (2006 Annual Report) considered the Interpretation and stated that:

- So far it has concluded that the adoption of them is unlikely to have a significant impact on the Group's results of operations and financial position except for HK(IFRIC) 12, *Service concession arrangements* ……

It further stated that:

- HK(IFRIC) 12 draws a distinction between two types of service concession arrangement.
- In one, the operator receives a financial asset, i.e. an unconditional contractual right to receive cash or another financial asset from the government in return for constructing or upgrading the public sector asset.
- In the other, the operator receives an intangible asset, i.e. no more than a right to charge for use of the public sector asset that it constructs or upgrades. A right to charge users is not an unconditional right to receive cash because the amounts are contingent on the extent to which the public uses the service.

Summary of HK(IFRIC)-Int 12

Case

China Everbright International Limited (2006 Annual Report) further clarified that:

- Certain BOT and TOT arrangements of the Group, such as the toll bridge project, waste-water treatment projects, waste-to-energy projects and methane-to-energy project, may be service concession arrangements under HK(IFRIC) 12.
- The Group has already commenced an assessment of the impact of HK(IFRIC) 12 but is not yet in a position to state the impact on the Group's results of operations and financial position.

Summary of HK(IFRIC)-Int 12

Case

China Communications Construction Company Ltd.

Annual Result Announcement of 10 April 2007 states that

- IFRIC 12, *Service Concession Arrangements*, effective for annual periods beginning on or after 1 Jan. 2008, was early adopted in 2006.
- In accordance with the IFRIC ……the assets under the concession arrangements may be classified as intangible assets or financial assets.
- The assets are classified as intangibles if the operator receives a right (a license) to charge users of the public service or as financial assets if paid by the granting authority.
- The Group classified the non-current assets linked to the long-term investment in these concession arrangements
  - as "concession assets" within intangible assets classification on the balance sheet if the intangible asset model is adopted.
- Once the underlying infrastructure of the concession arrangements is completed,
  - the concession assets will be amortised over the term of the concession on a straight-line basis under the intangible asset model.

Effective Date and Transition

- An entity shall apply this Interpretation for
  - annual periods beginning on or after 1 January 2008.
- Earlier application is permitted.
- If an entity applies this Interpretation for a period beginning before 1 January 2008,
  - it shall disclose that fact.
- Subject to the operator's impracticability to apply this interpretation, changes in accounting policies are accounted for in accordance with HKAS 8,
  - i.e. retrospectively.

Capital Disclosures – For 2007

Capital Disclosures

What is capital? Is it ……

Capital = Assets – Liabilities

- HKAS 1.BC47 considers “whether an entity can have a view of capital that differs from what IFRSs define as equity.”
- It further clarifies that, although for the purposes of this disclosure capital would often equate with equity as defined in HKFRSs,
  - it might also include or exclude some components.
- It also noted that the capital disclosure in HKAS 1 is intended to give entities the opportunity to describe
  - how they view the components of capital they manage, if this is different from what HKFRSs define as equity ……

Capital Disclosures

Based on the Framework & HKFRSs, the accounting equation should be:

~~Capital~~ = Assets – Liabilities

Equity = Assets – Liabilities

- An entity’s capital may be part of its equity plus part of its liabilities, depending on how it manage “its capital” ……

Capital Disclosures

- An entity shall disclose information that enables users of its financial statements to evaluate
  - the entity's *objectives*, *policies* and *processes* for managing capital.

- To comply with the capital disclosures, the entity discloses the following:
  a) **qualitative information** about its objectives, policies and processes for managing capital, including (but not limited to):
     i) a description of what it manages as capital;
     ii) when an entity is subject to externally imposed capital requirements, the **nature** of those requirements and **how** those requirements are incorporated into the management of capital; and
     iii) **how it is meeting its objectives** for managing capital.

Capital Disclosures

- An entity shall disclose information that enables users of its financial statements to evaluate
  - the entity's *objectives*, *policies* and *processes* for managing capital.

- To comply with the capital disclosures, the entity discloses the following:
  b) summary quantitative data about what it manages as capital.
     Some entities regard some financial liabilities (e.g. some forms of subordinated debt) as part of capital.
     Other entities regard capital as excluding some components of equity (e.g. components arising from cash flow hedges).
  c) any changes in (a) and (b) from the previous period.

Capital Disclosures

- An entity shall disclose information that enables users of its financial statements to evaluate
  - the entity's *objectives*, *policies* and *processes* for managing capital.

- To comply with the capital disclosures, the entity discloses the following:
  d) whether during the period it complied with any externally imposed capital requirements to which it is subject.
  e) when the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

  These disclosures shall be based on the information provided internally to the entity's key management personnel.

Capital Disclosures

Case

香港交易所 HKEx

- Early adopted capital disclosure in 2005 and its annual report states that (extract only):
  - The Group's objectives when managing capital are:
    - To safeguard the Group's ability to continue as a going concern, so that it continues to provide returns for shareholders and benefits for other stakeholders;
    - To support the Group's stability and growth; and
    - To provide capital for the purpose of strengthening the Group's risk management capability.

Capital Disclosures

Case

- Early adopted capital disclosure in 2005 and its annual report states that (extract only):
  - The Group actively and regularly reviews and manages its capital structure to ensure optimal capital structure and shareholder returns, taking into consideration the future capital requirements of the Group and capital efficiency ……
  - The Group adopts a dividend policy …… while retaining 10 per cent of the profit as capital of the Group for future use.
  - The Group has set aside $1,500 million of retained earnings for the purpose of strengthening the risk management regime of the clearing houses and supporting their roles as central counterparties.
  - As in prior years, the Group monitors capital by reviewing the level of capital that is at the disposal of the Group (“adjusted capital”).
  - Adjusted capital comprises all components of shareholders’ equity
    - other than the hedging reserve relating to cash flow hedges, designated reserves and investment revaluation reserve ……

Capital Disclosures – Transition

- Entities shall apply the amendments of capital disclosure for
  - annual periods beginning on or after 1 January 2007.
- Early application is encouraged.

HKFRS 7 Financial Instruments: Disclosure

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Disclosure Amended by HKFRS 7

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

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

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

   how the entity manages those risks.

Significance
- Balance sheet
- Income statement
- Other disclosures

Nature and Extent
- Qualitative disclosures
- Quantitative disclosures

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Disclosure Amended by HKFRS 7

- HKFRS 7 supersedes (from 1 Jan. 2007)
  - Full HKAS 30
  - Para. 51 to 95 of HKAS 32
- As compared with HKAS 30 and 32, HKFRS 7 has the following attributes:
  1. <u>Apply to all entities</u> while HKAS 30 applies to financial institution only
  2. Is <u>more correlation</u> with the categories of financial instruments as defined in <u>HKAS 39</u>
  3. Aim at <u>simplifying the disclosure</u> requirements of HKAS 32 on risks but <u>introduced some new disclosures</u> ……
  4. HKAS 32 has exemption for comparative on first year of adoption but HKFRS 7 only provides exemption on the nature and extent of risks.

Significance

Nature and Extent

1. Significance of Financial Instruments

Significance

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

Balance Sheet

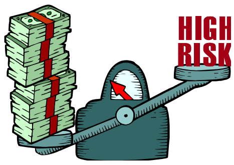
Income Statement

Other Disclosures

2. Nature and Extent of Risks

Nature and Extent

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



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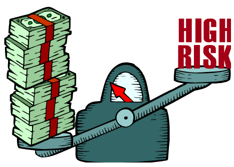
2. Nature and Extent of Risks

Nature and Extent

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



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2. Nature and Extent of Risks

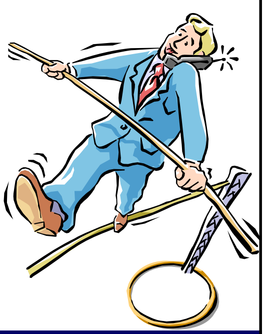
Nature and Extent

In HKAS 32	In HKFRS 7
Market Risk	Market Risk
Currency Risk	Currency Risk
FV Interest Rate Risk	Interest Rate Risk
Price Risk	Other Price Risk
Credit Risk	Credit Risk
Liquidity Risk	Liquidity Risk
Cash Flow Interest Rate Risk	

2. Nature and Extent of Risks

Nature and Extent → Qualitative Disclosures

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



2. Nature and Extent of Risks

Nature and Extent → Quantitative Disclosures

- For each type of risk arising from financial instruments, an entity shall disclose:
  - Summary quantitative data about its exposure to that risk at the reporting date.
- The level of detail of such disclosure is based on:
  - The information provided internally to key management personnel of the entity (as defined in HKAS 24 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.
- If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period,
  - an entity shall provide further information that is representative.

2. Nature and Extent of Risks

Nature and Extent → Quantitative Disclosures

Market risk

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

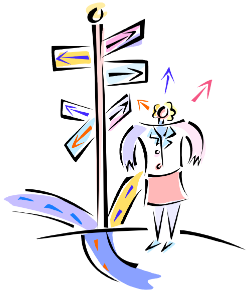
2. Nature and Extent of Risks

Nature and Extent → Quantitative Disclosures

Market risk – Sensitivity Analysis for Each Type of Market Risk

- An entity shall disclose:
  a) a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing:
     - how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;

  b) the methods and assumptions used in preparing the sensitivity analysis; and
  c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.



2. Nature and Extent of Risks

Nature and Extent → Quantitative Disclosures

Market risk – Sensitivity Analysis That Reflects Interdependencies Between Risks Variables

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

2. Nature and Extent of Risks

Case

香港交易所 HKEx

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

– Risk management techniques, such as Value-at-Risk ("VaR") based on historical simulation and portfolio stress testing, are used to identify, measure and control foreign exchange risk, equity price risk and interest rate risks of the Group's investments.
– VaR measures
  - the expected maximum loss
  - over a given time interval (a holding period of 10 trading days is used by the Group)
  - at a given confidence level (95 per cent confidence interval is adopted by the Group)
  - based on historical data (one year is used by the Group).
– The Board sets a limit on total VaR of the Group and VaR is monitored on a weekly basis ……

How would you determine them?

2. Nature and Extent of Risks

Case

香港交易所 HKEx

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

– The VaR for each risk factor and the total VaR of the investments of the Group and HKEx during the year were as follows:

	Group			HKEx		
	2005			2005		
	Average $million	Highest $million	Lowest $million	Average $million	Highest $million	Lowest $million
Foreign exchange risk	5	6.1	3.6	0.2	0.7	-
Equity price risk	8.5	11.2	6.6	-	-	-
Interest rate risk	20.5	24	14.4	-	-	-
Total VaR	23.5	26.9	20.4	0.2	0.7	-

3. Effective Date and Transition

- An entity shall apply HKFRS 7 for annual periods beginning on or after 1 January 2007.
- Earlier application is encouraged.
  - If an entity applies HKFRS 7 for an earlier period, it shall disclose that fact.
- If an entity applies HKFRS 7 for annual periods beginning before 1 January 2006,
  - it need not present comparative information for the disclosures about the nature and extent of risks arising from financial instruments.

- HKAS 32.97 requires that if comparative information for prior periods is not available when HKAS 32 is first applied,
  - such information need not be presented, but an entity shall disclose that fact.

How Do You Determine Them ……

Case

Reference to the time horizon and confidence level of some entities used in VaR analysis ……

Entity name	Time horizon	Confidence level
HSBC	1 day	99%
BoC-HK	1 day	99%
Standard Chartered	1 day	97.5%
HKMA	1 month	95%
HKEx	10 days	95%

A Simple Quantitative Example

Example

Assume you have a financial asset with the following details:

- $ 10 million in HSBC shares
- Volatility is 2% per day and 32% per year

Find 10-day VaR at 99% confidence level

- The standard deviation of daily changes in the value of the asset is:
  2% of $ 10 million = $ 200,000
- Assuming the changes on successive days are independent, the standard deviation over 10-day period to be
  $\$\ 200{,}000 \times \sqrt{10} = \$\ 632{,}456$
- 99% confidence level implies $N(-2.33) = 0.01$
- Thus, 10-day 99% VaR for that $10 million portfolio is:
  $632,456 x 2.33 = $ 1,473,621

Modified from *Options, Futures, & Other Derivatives*, by John C. Hull, 4th Edition, Prentice Hall, 2000

Today's Agenda

Potential development and amendments in 2007 to 2008

Is it the end ……

Probably result in amendment to the corresponding HKFRSs soon

Amended HKFRS/IFRS

- HKFRS/IAS 23 *Borrowing Costs*

Amended IFRIC Interpretation (but not in HK yet)

- IFRIC 13 *Customer Loyalty Programmes*
- IFRIC 14 *IAS 19 — The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*

Other proposals

- Amendments to IAS 1 and IFRS 3 to be issued within this year
- IFRSs for SME
- Amendments to IAS 24 *Related Party Disclosures*
- Other ……

HKAS/IAS 23 Borrowing Costs

Amendments to IAS 23 issued in March 2007

- Converged to the practice in US
- HK should follow soon
- Apply to borrowing costs relating to qualifying assets for which it begins capitalisation on or after 1 January 2009
- Remove the option of immediately recognising the borrowing costs as expenses
- IAS 23 does not apply to borrowing costs directly attributable to the acquisition, construction and production of a qualifying assets measured at fair value, say biological asset

Benchmark – Expenses

Allowed Alternative – Capitalisation

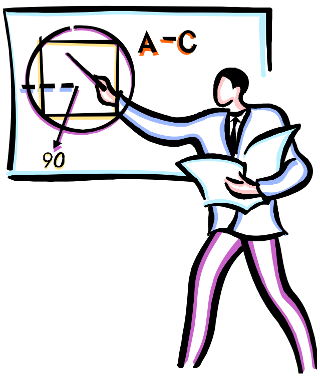
Forthcoming Change in 2007 – 2008

IAS 1 *Presentation of Financial Statements* (Phase A)

- Converged to US and to be finalised within 2007
- Up to June 2007, decision made:
  - A complete set of financial statements include:
    - Balance sheet → Statement of financial position
    - Profit and loss a/c → Statement of comprehensive income
    - Cash flow statement → Statement of cash flows
    - Statement of changes in equity
  - But titles remain non mandatory
  - Changes in equity divided between owner and non-owner changes in equity
  - Single & two-statement approach in presenting non-owner changes in equity ……

Annual Update on HKFRSs (IFRSs)

8 September 2007



Full set of slides can be found in
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