HKAS 39 Workshop

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Overview of HKAS 39

HKAS 32 ⇒ Disclosure and presentation
HKAS 39 ⇒ Recognition and measurement

- The most interesting standards
- The most lengthiest standards
- The most complex standards
- Cover some unusual or more complex contracts
- But also cover some very simple elements in the financial statements, for example:
  - Cash, trade receivable ……
  - Share capital, trade payable, bank loans ……
- Many additions and amendments as well, including HKFRS 7 ⇒ Disclosure

Overview of HKAS 39

HKAS 32

- Aims at enhancing financial statement users' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows.
- Contains requirements for the presentation of financial instruments and identifies the information that should be disclosed about them.

HKAS 39

- Aims at establishing principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

Before HKFRS 7 effective in 2007

Overview of HKAS 39

HKAS 32

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

HKFRS 7 (effective in 2007)

- Disclosure requirements

HKAS 39

- Classification of financial instruments
- Recognition and derecognition of financial instruments
- Measurement of financial instruments
- Derivatives and embedded derivatives
- Hedging and hedge accounting

Today's Agenda

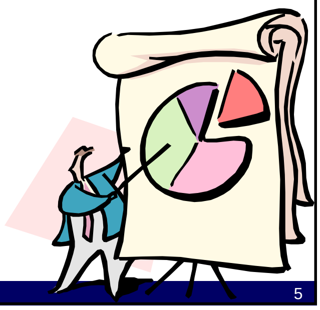
Focus on HKAS 39

- Definitions
- Embedded Derivatives
- Definitions and Classification
- Initial recognition and measurement
- Financial assets – measurement
- Financial liabilities – measurement
- Derecognition

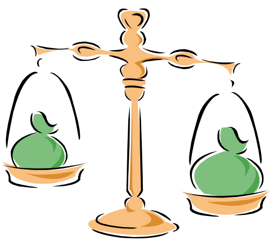
Simple but Comprehensive

Key Issues

Over 50 Cases & Examples

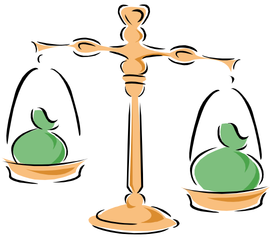


Definitions



Definitions

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 instrument → Financial liability or Equity instrument → of another entity

Definitions – Financial Instruments

Financial asset is any asset that is:
- Cash
- An equity instrument of another entity
- A contractual right
  - i) to receive cash or another financial asset from another entity
  - ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity
- A contract that will or may settled in the entity's own equity instruments and is
  - i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. *(For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.)*

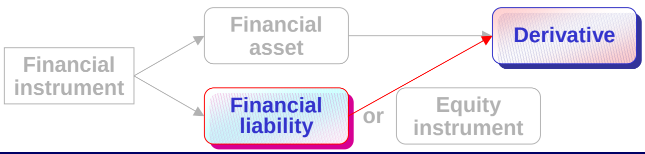
Financial instrument → Financial asset → Derivative

Financial instrument → Financial liability or Equity instrument

Definitions – Financial Instruments

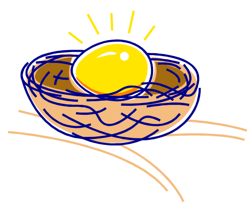
Financial liability is any liability that is

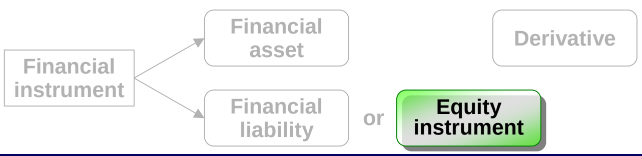
- A contractual right
  - i) to deliver cash or another financial asset from another entity
  - ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity
- A contract that will or may settled in the entity's own equity 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.)*



Definitions – Financial Instruments

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





Definitions – Financial Instruments

Example 1

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.

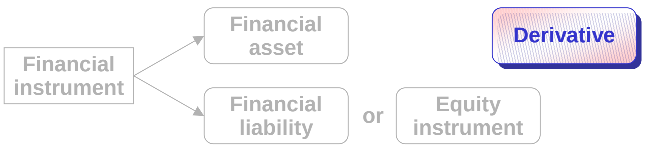
Definitions – Derivative

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

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

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

Settled at a future date
c) it is settled at a future date.



Definitions – Derivative

Example 2

Derivative

Typical example:
- Future and forward
- Swap and options

Value change based on an underlying

Little or no initial net investment

Settled at a future date

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

Definitions – Derivative

Example 3

Value change based on an underlying √

Little or no initial net investment √

Settled at a future date √

2 Non-Derivative Transactions

- Entity A makes a 5-year fixed rate loan to Entity B
- Entity B at the same time makes a 5-year variable rate loan for the same amount to Entity A.
- There are no transfers of principal at inception of the 2 loans, since A and B have a netting agreement
- Is this a derivative under HKAS 39?

Yes, it meets the definition of a derivative.
- The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment.

Definitions – Derivative

Example 3

Value change based on an underlying

Little or no initial net investment

Settled at a future date

- Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative.
- Indicators of this would include:
  - They are entered into at the same time and in contemplation of one another
  - They have the same counterparty
  - They relate to the same risk
  - There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction
- The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in HKAS 39 does not require net settlement

Definitions – Derivative

Example 4

Value change based on an underlying √

Little or no initial net investment ✗

Settled at a future date √

Prepaid forward

- An entity enters into a forward contract to purchase shares of stock in 1 year at the forward price.
- It prepays at inception based on the current price of the shares.
- Is the forward contract a derivative?

No.

- The forward contract fails the "little or no initial net investment" test for a derivative.

Definitions – Derivative

Example 5

Value change based on an underlying √

Little or no initial net investment √

Settled at a future date √

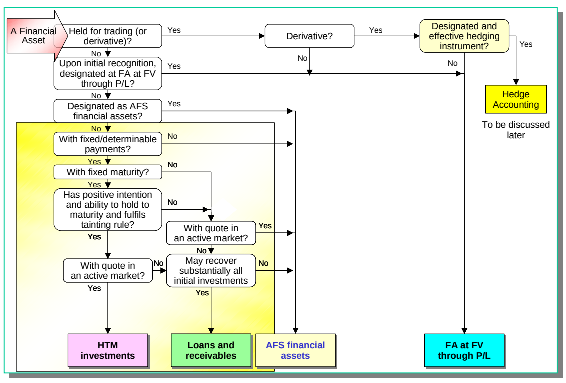
Margin deposit (or account)

- Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts.
- Is the margin account part of the initial net investment?

No!

- The margin account is not part of the initial net investment in a derivative instrument.
- Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets.
- Margin accounts are separate assets that are accounted for separately.

Embedded Derivatives



Will derivative elements in the financial assets affect the classification?

Embedded Derivatives

Hybrid (Combined) Contract

Host Contract

Embedded Derivative

HKAS 39 introduce Embedded Derivative

- it is a component of a hybrid (combined) instrument that also include a non-derivative host contract
  - with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative

- An **embedded derivative** causes some or all of the cash flows that otherwise would be required by the contract
  - to be modified according to a variable,
    - say specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable.

- A **derivative** that **Remember what derivative is?**
  - is attached to a financial instrument
  - but is contractually transferable independently of that instrument, or
  - has a different counterparty from that instrument

  is NOT an embedded derivative, BUT a separate financial instrument.

Embedded Derivatives

Example 6

Host Contract

Embedded Derivative

- Investments in convertible bonds (with equity conversion feature)
- Equity-indexed interest or principal payments embedded in a host debt instrument (equity-linked interest or principal payments)
- An option or automatic provision to extend the remaining term to maturity of a debt instrument
- A call, put, surrender or prepayment option embedded in a host debt instrument
- Equity kicker
- Equity-linked notes
- Equity call and put options
- Inflation-indexed lease payments
- Contingent rentals
- More …… but so?

Embedded Derivatives

Hybrid (Combined) Contract

Host Contract

Embedded Derivative

HKAS 39 requires an embedded derivative

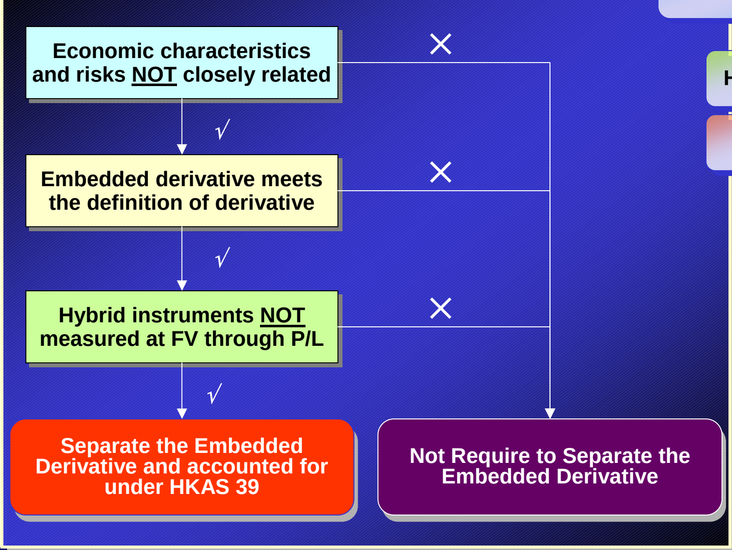
- shall be separated from the host contract and
- accounted for as a derivative under HKAS 39 if, and only if:
  a. the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract
  b. a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
  c. the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss

Embedded Derivatives

Hybrid (Combined) Contract

Host Contract

Embedded Derivative



Embedded Derivatives

Economic characteristics and risks NOT closely related

To assess economic characteristics and risks

- If a host contract
  - has no stated or predetermined maturity and
  - represents a residual interest in the net assets of an entity
    - ➢ then its economic characteristics and risks are those of an equity instrument, and
    - ➢ an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related.
- If the host contract
  - is not an equity instrument and
  - meets the definition of a financial instrument
    - ➢ then its economic characteristics and risks are those of a debt instrument.

- Guarantee Fund?
- Alternatively, should we name it as …… bond with index-linked interest?

Embedded Derivatives

Example 7

Economic characteristics and risks NOT closely related

Specific examples of where the characteristics and risks are regarded as closely related and NO separation is required:

- embedded derivatives based on interest rates or an interest rate index that can change the amount of interest that is paid on an interest-bearing debt instrument;
- a floor or cap on a debt instrument as long as it is out of the money; and
- an embedded foreign currency derivative in a non-financial instrument (such as a contract for the purchase or sale of a non-financial item), provided that
  - it is not leveraged and does not contain an option feature and
  - requires payments denominated in one of the following currencies:
    - i) the functional currency of any substantial party to the contract;
    - ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
    - iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g. a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

Embedded Derivatives

Example 8

Economic characteristics and risks NOT closely related

Specific examples of where the characteristics and risks are regarded as closely related and NO separation is required:

- An embedded prepayment option in an interest-only or principal-only strip, provided the host contract
  - i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and
  - ii) does not contain any terms not present in the original host debt contract.
- An embedded derivative in a host lease contract, if the embedded derivative is
  - i) an inflation-related index, such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment),
  - ii) contingent rentals based on related sales, or
  - iii) contingent rentals based on variable interest rates.

Embedded Derivatives

If separation is required and can be measured

⇒ Host Contract shall be accounted for under applicable HKFRS

⇒ Embedded Derivative shall be accounted under HKAS 39 as a derivative

If separation is required but cannot be measured

⇒ Entire Hybrid (Combined) Contract is classified as financial instrument that is held for trading

↑ **Separate the Embedded Derivative and accounted for under HKAS 39**

If separation is not required

⇒ Hybrid (combined) contract shall be accounted for under applicable HKFRS

↑ **Not Require to Separate the Embedded Derivative**

Embedded Derivatives

Hybrid (Combined) Contract

Host Contract

Embedded Derivative

To separate embedded derivative

- An embedded non-option derivative (such as an embedded forward or swap)
  - is separated from its host contract on the basis of its stated or implied substantive terms,
  - so as to result in it having a fair value of zero at initial recognition.
- An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption)
  - is separated from its host contract on the basis of the stated terms of the option feature.
- The initial carrying amount of the host instrument is
  - the residual amount after separating the embedded derivative.

Host Contract = Hybrid (Combined) Contract - Embedded Derivative

Embedded Derivatives

Hybrid (Combined) Contract

Host Contract

Embedded Derivative

To separate embedded derivative

- If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument)
  - ➢ the fair value of the embedded derivative is the difference between
    - the fair value of the hybrid instrument, and
    - the fair value of the host contract,

    if those can be determined under HKAS 39.

Embedded Derivative = Hybrid (Combined) Contract - Host Contract

- If the entity is still unable to determine the fair value of the embedded derivative using the above method,
  - ➢ the combined instrument is treated as held for trading.

Embedded Derivatives

Example 9

Fair value cannot be reliably measured

If an embedded derivative that is required to be separated cannot be reliably measured because it will be settled by an unquoted equity instrument whose fair value cannot be reliably measured, is the embedded derivative measured at cost?

No.

- In this case, the entire combined contract is treated as a financial instrument held for trading.
- If the fair value of the combined instrument can be reliably measured, the combined contract is measured at fair value.
- The entity might conclude, however, that the equity component of the combined instrument may be sufficiently significant to preclude it from obtaining a reliable estimate of the entire instrument.
- In that case, the combined instrument is measured at cost less impairment.

Embedded Derivatives

Example 10

Index-linked Principal

- Entity A purchases a 5-year equity-index-linked note with an original issue price of $10 at a market price of $12 at the time of purchase.
- The note requires no interest payments before maturity.
- At maturity, the note requires
  - Payment of the original issue price of $10
  - Plus a supplemental redemption amount that depends on whether
    - a specified share price index > a predetermined level at the maturity date.
  - If the share index < or = the predetermined level
    - the supplemental redemption amount is zero
  - If the share index > the predetermined level
    - the supplemental redemption amount equal a factor of level of the share index at maturity
- Entity A has the positive intention and ability to hold the note to maturity.
- Can Entity A classify the note as a held-to-maturity investment?

Embedded Derivatives

Example 10

Index-linked Principal

Yes, subject to the separation of embedded derivative.

- The note can be classified as a HTM investment because
  - it has a fixed payment of $10 and fixed maturity and
  - Entity A has the positive intention and ability to hold it to maturity.
- However, the equity index feature is a call option not closely related to the debt host, which must be separated as **an embedded derivative**.
- The purchase price of $12 is allocated between
  - the host debt instrument and
  - the embedded derivative
- For example
  - if the fair value of the embedded option at acquisition is $4
  - the host debt instrument is measured at $8 on initial recognition
  - Then, the discount of $2 that is implicit in the host bond (principal of $10 minus the original carrying amount of $8) is amortised to profit or loss over the term to maturity of the note using the effective interest method.

Embedded Derivatives

Example 11

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

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

Yes, but ……

- The commodity-indexed or equity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value (HKAS 39.11).
- HKAS 39.12 (stated at fair value through profit or loss) is not applicable
  - since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

Embedded Derivatives

Hybrid (Combined) Contract

Host Contract

Embedded Derivative

Economic characteristics and risks NOT closely related

√

Embedded derivative meets the definition of derivative

√

Hybrid instruments NOT measured at FV through P/L

√

×

×

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Separate the Embedded Derivative and accounted for under HKAS 39

Not Require to Separate the Embedded Derivative

Implies:

- So long as the Hybrid (Combined) Contract is measured at FV through P/L
- No separation is required

Management can choose it to avoid separation ……

Embedded Derivatives

香港交易所 HKEx

Case 1

HKEX *(Consolidated financial statements published on 28 Feb. 2005)*

"From 1 January 2004, investments of the Group are classified under the following categories:

Financial assets at fair value through profit or loss

This category comprises financial assets held for trading and those designated as fair value through profit or loss at inception ……

Debt securities and bank deposits with embedded derivatives for yield enhancement whose economic characteristics and risks are not closely related to the host securities and deposits are designated as financial assets at fair value through profit or loss.

Available-for-sale financial assets

This category comprises financial assets which are non-derivatives and are designated as available-for-sale financial assets or not classified under other investment categories.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, and with no intention of trading the receivables. Bank deposits are treated as loans and receivables and are disclosed as time deposits and cash equivalents."

Definitions and Classification

Financial instrument
- Financial asset
- Financial liability

Definitions and Classification

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

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

- Initial recognition and measurement principle for financial assets and financial liabilities are the same (to be discussed later)
- 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.

Definitions and Classification

Financial asset

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 it is:
   i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
   ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
   iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

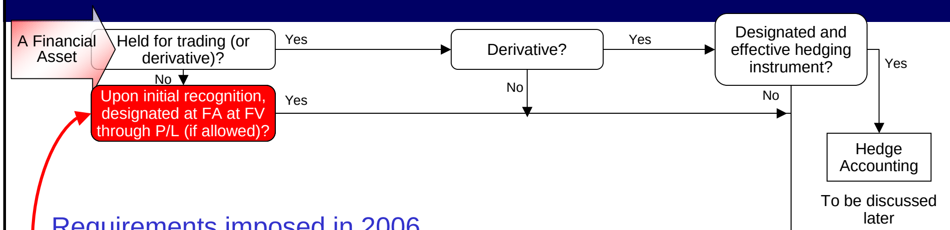
b) Upon **initial recognition** it is **designated** by the entity as at fair value through profit or loss (only if the entity meets any one of the conditions in HKAS 39)

An entity has NO choice

If an entity meets the condition, it has a choice (since 2006)

Definitions and Classification

Financial asset



Requirements imposed in 2006

– 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

FA at FV through P/L

Definitions and Classification

Financial asset

FA at FV through P/L

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

Effective from 1.1.2006: 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 (in order to avoid separation of embedded derivative from hybrid contract), 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

Definitions and Classification

Financial asset

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

Definitions and Classification

Financial asset

- 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

Definitions and Classification

Financial asset

Example 12

- 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

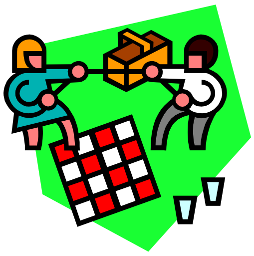
3 Conditions to Designate

Definitions and Classification

Financial asset

- 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

Definitions and Classification

Financial asset

Example 13

- 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

Definitions and Classification

Financial asset

Example 14

- 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

Definitions and Classification

Financial asset

FA at FV through P/L | **AFS financial assets**

Definition – for Available-for-sale financial assets

- Those non-derivative financial assets that are designated as available for sale, or
- Those not classified into other categories

An entity has a choice

- Implies
  - ⇒ Except for those held for trading, all the remaining financial assets can be designated as AFS financial assets
  - ⇒ Loans and receivables and HTM investments can also be initially designated as AFS financial assets

Definitions and Classification

Financial asset

Case 2

Li & Fung Limited

- In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:
  - Available-for-sale financial assets are non-derivatives that are either
    - designated in this category or
    - not classified in any of the other categories (i.e. loans and receivables, financial assets at fair value through profit or loss and held-to-maturity investments).
  - They are included in non-current assets unless management intends to dispose of the investment within 12 months of the balance sheet date.

Definitions and Classification

Financial asset

FA at FV through P/L | AFS financial assets | **HTM investments**

Definition
for Held-to-Maturity Investments

- Non-derivative financial assets with fixed or determinable payments and fixed maturity
- That the entity has the positive intention and ability to hold to maturity, other than
  - those initially designated as FA at FV through P/L
  - those designated as AFS financial assets
  - those that meet the definition of loans and receivables

- A debt instrument with a variable interest rate can satisfy the criteria for a HTM investment.
- Equity instruments cannot be HTM investments either
  - because they have an indefinite life (such as ordinary shares) or
  - because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights).

Definitions and Classification

Financial asset

Example 15

HTM investments

Definition
for Held-to-Maturity Investments

Bond with index-linked interest

- Entity A buys a bond with a fixed payment at maturity and a fixed maturity date.
- The bond's interest payments are indexed to the price of a commodity or equity.
- Entity A has positive intention and ability to hold the bond to maturity.
- Can Entity A classify the bond as a HTM investment?

Yes.
- However, the commodity-indexed or equity-indexed interest payments result in an Embedded Derivative that is separated and accounted for as a derivative at fair value.

Definitions and Classification

Financial asset

HTM investments

Definition
for Held-to-Maturity Investments

No Positive Intention to Hold to Maturity

- An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:
  a) the entity intends to hold the financial asset for an undefined period;
  b) the entity stands ready to sell the financial asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the entity) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or
  c) the issuer has a right to settle the financial asset at an amount significantly below its amortised cost.

Definitions and Classification

Financial asset

Example 16

HTM investments

Definition
for Held-to-Maturity Investments

Callable bond

- Entity A buys a callable bond and the bond issuer has a call option.
- Can Entity A classify the bond as a HTM investment?

Yes

- If the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount.
- The call option of the issuer, if exercised, simply accelerates the asset's maturity.

Definitions and Classification

Financial asset

Example 17

HTM investments

Definition
for Held-to-Maturity Investments

Puttable bond

- Entity A buys a puttable bond and Entity A has a put option to require the issuer to redeem the bond.
- Can Entity A classify the bond as a HTM investment?

No!

- A financial asset that is puttable (i.e. the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a HTM investment.
- Because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.

Definitions and Classification

Financial asset

Subject to Tainting Rule below → HTM investments

Definition for Held-to-Maturity Investments

An entity shall not classify any financial assets as held to maturity

- if the entity has,
  - during the current financial year or
  - during the two preceding financial years,
  - sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity
    (more than insignificant in relation to the total amount of held-to-maturity investments)

The sales or reclassifications are exempted from the above Tainting Rule if they:

- are so close to maturity or the financial asset's call date (for example, less than 3 months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
- occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or
- are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

Definitions and Classification

Financial asset

Example 18

Subject to Tainting Rule below → HTM investments

Definition for Held-to-Maturity Investments

Sale of HTM investments

- Entity A sells $1,000 bonds from its HTM portfolio with $5,000 bonds on interim date of 2003 before the bonds will be matured in 2007.
- Since Entity A wants to realise the appreciation in market price of the bonds.

- The disposed bonds would be over an insignificant amount of the whole portfolio and it is not an exemption from Tainting Rule.
- The sale of part of the HTM portfolio "taints" that the entire portfolio and all remaining investments in the HTM category must be reclassified.
- Entity A will be prohibited from classifying any assets as HTM investments for 2 full financial years, until the year of 2006.

Definitions and Classification

Financial asset

Example 19

Subject to **Tainting Rule** below → HTM investments

Definition
for Held-to-Maturity Investments

Downgrade of Credit Rating

Would a sale of a held-to-maturity investment following a downgrade of the issuer's credit rating by a rating agency raise a question about the entity's intention to hold other investments to maturity?

Not necessarily

- A downgrade is likely to indicate a decline in the issuer's creditworthiness.
- HKAS 39 specifies that a sale due to a significant deterioration in the issuer's creditworthiness could satisfy the condition in HKAS 39 and therefore not raise a question about the entity's intention to hold other investments to maturity.
- However, the deterioration in creditworthiness must be significant judged by reference to the credit rating at initial recognition.
- Also, the rating downgrade must not have been reasonably anticipated when the entity classified the investment as held to maturity in order to meet the condition in HKAS 39.

Definitions and Classification

Financial asset

Example 20

Subject to **Tainting Rule** below → HTM investments

Definition
for Held-to-Maturity Investments

Different categories of HTM Investments

Can an entity apply the **Tainting Rule** for held-to-maturity classification separately to different categories of HTM investments, such as

– debt instruments denominated in US dollars and
– debt instruments denominated in Euro?

No.

- The **Tainting Rule** is clear
  - ➢ if an entity has sold or reclassified more than an insignificant amount of HTM investments, it cannot classify any financial assets as HTM investments.

Definitions and Classification

Financial asset

Example 21

Subject to **Tainting Rule** below → **HTM investments**

Definition for Held-to-Maturity Investments

Different entities in a group

Can an entity apply the **Tainting Rule** separately to HTM investments held by different entities in a consolidated group, for example, if those group entities are in different countries with different legal or economic environments?

No.

- If an entity has sold or reclassified more than an insignificant amount of investments classified as held-to-maturity in the consolidated financial statements, it cannot classify any financial assets as HTM investments in the consolidated financial statements unless the exemption conditions in HKAS 39 are met.

Definitions and Classification

Financial asset

Case 3

Hang Seng Bank *(2004 Annual Report)*

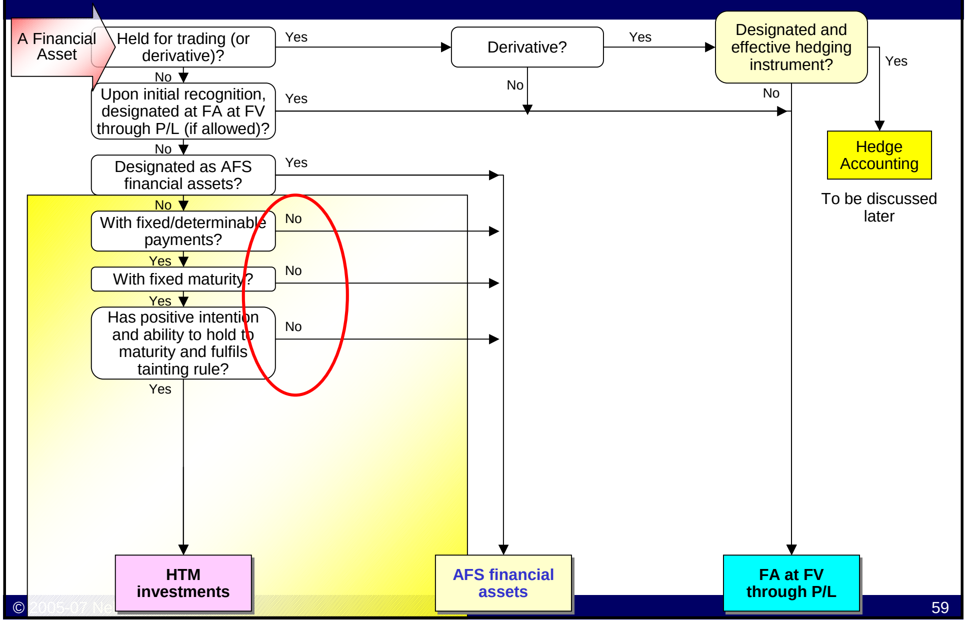
- On 1 January 2005, the Group has *reclassified most* of its Held-to-Maturity debt securities as Available-for-Sale securities.
- The change in fair value will cause *volatility* to the shareholders' equity.
- On transition, the revaluation gain or loss will be adjusted through a reserve in the shareholder's equity.
- No restatement of the 2004 accounts is required.

Explained why!

恒 生 銀 行 HANG SENG BANK

Definitions and Classification

Financial asset



Definitions and Classification

Financial asset

FA at FV through P/L | AFS financial assets | HTM investments | **Loans and receivables** | Definition

- Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than
  - those the entity intends to sell immediately or in the near term (which shall be classified as held for trading)
  - those initially designated as FA at FV through P/L
  - those initially designated as AFS financial assets
  - those for which the holder may not recover substantially all of its the initial investment, other than because of credit deterioration, which shall be classified as AFS financial assets
- An interest acquired in a pool of assets that are not loans or receivables is not a loan or receivable (for example, an interest in a mutual fund or a similar fund).
- Examples include: loan assets, trade receivables, rental deposits, deposits held by banks ……

Definitions and Classification

Financial asset

Example 22

Loans and receivables Definition

Classification of Investment in Preference Share

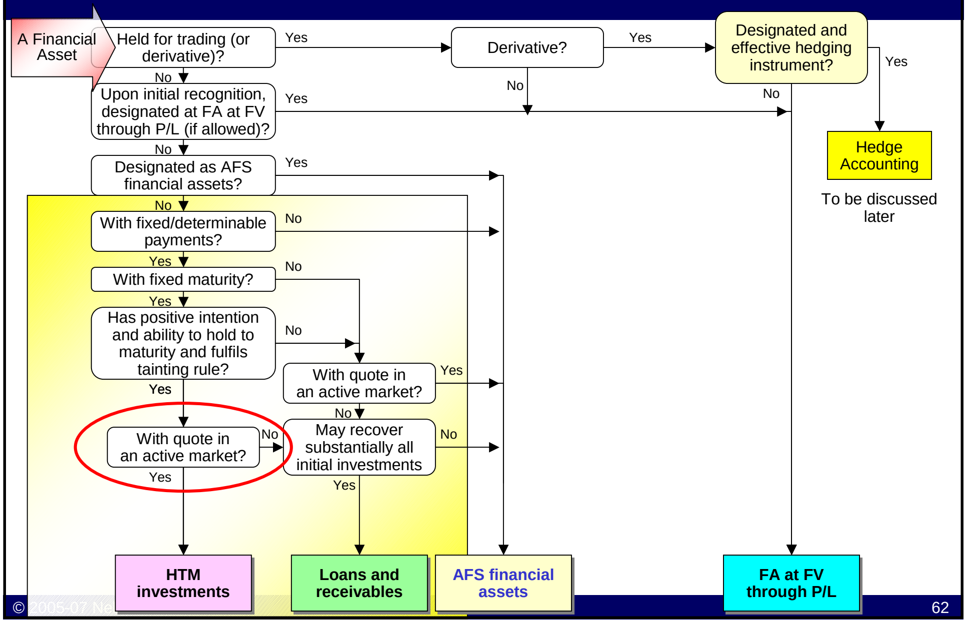
Can an equity instrument, such as a preference share, with fixed or determinable payments be classified within loans and receivables by the holder?

Yes.

- If a non-derivative equity instrument would be recorded as a liability by the issuer, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holder, provided the definition is otherwise met.
- HKAS 32 provides guidance about the classification of a financial instrument as a liability or as equity from the perspective of the issuer of a financial instrument.
- If an instrument meets the definition of an equity instrument under HKAS 32, it cannot be classified within loans and receivables by the holder.

Definitions and Classification

Financial asset



Initial Recognition & Measurement

Financial instrument
- Financial asset
- Financial liability

Initial Recognition & Measurement

Financial instrument
- Financial asset
- Financial liability

Initial Recognition
- Trade Date Accounting
- Regular Way of Financial Assets

- An entity shall 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 instruments
  - Implies **trade date accounting**
  - Except for **a regular way purchase or sale of financial assets** (to be discussed)
- As a consequence of this principle, an entity recognise all of its contractual rights and obligations under derivatives in its balance sheet as assets and liabilities respectively.
- Examples:
  - Committing to a purchase of equity securities
  - Committing to write a derivative option

Initial Recognition & Measurement

Financial instrument → Financial asset / Financial liability → Initial Recognition

Initial Recognition
- Trade Date Accounting
- Regular Way of Financial Assets

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*

Why?

No transaction cost will be initially recognised for financial instruments ***at fair value through profit or loss***

Initial Recognition & Measurement

Financial asset ↔ Derivative

- **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.
- A regular way purchase or sale of financial assets shall be recognised (and derecognised) using either
  - **trade date accounting**, or
  - **settlement date accounting**
- The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets

- A contract that requires or permits net settlement of the change in the value of the contract is NOT a regular way contract.
- Instead, such a contract is accounted for as
  - **a derivative in the period between the trade date and the settlement date**

Initial Recognition & Measurement

Example 23

Trade Date vs. Settlement Date Accounting

- On 28 June 2011, Entity X agrees to purchase a bond for settlement on 1 July 2011 at $10 million.
- On 30 June 2011, the fair value of the bond is $10.1 million.
- On 1 July 2011, the bond purchase is settled for $10.0 million and the fair value remains as $10.1 million.
- What would be the impact on the balance sheet of the bond purchase at each of the dates of 28 June, 30 June and 1 July?

- The balance sheet impact is shown for both the settlement date approach and the trade date approach.
- The example illustrates initial measurement of the bond purchase under two scenarios:
  1) subsequently carried at fair value (AFS financial assets) and
  2) subsequently carried at amortised cost.

Initial Recognition & Measurement

Example 23

Trade Date vs. Settlement Date Accounting

	Settlement date accounting		**Trade date accounting**	
Bond measured at:	*Fair value*	*Amortised cost*	*Fair value*	*Amortised cost*
28 June 2011				
Financial asset - bond	–	–	10.0	10.0
Financial liability	–	–	(10.0)	(10.0)
30 June 2011				
Financial asset - receivable (revaluation gain)	0.1	–	–	–
Financial asset - bond	–	–	10.1	10.0
Financial liability	–	–	(10.0)	(10.0)
Equity	(0.1)	–	(0.1)	–
1 July 2011				
Financial asset - receivable (revaluation gain)	–	–	–	–
Financial asset-bond	10.1	10.0	10.1	10.0
Cash paid	(10.0)	(10.0)	(10.0)	(10.0)
Equity	(0.1)	–	(0.1)	–

Initial Recognition & Measurement

Example 24

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

Example 25

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.

- On initial recognition, Entity A should recognise the carrying amount of the loan at the fair value of the payments that it will receive from the related party.
- How is the fair value of the payments at initial recognition calculated?

Initial Recognition & Measurement

Example 25

	Cash inflow	Discount factor	Present value
31.12.2005	$50,000 x 2% = $ 1,000	$1 / (1 + 6\%)^1$	$ 943
31.12.2006	$ 1,000	$1 / (1 + 6\%)^2$	$ 890
31.12.2007	$ 51,000	$1 / (1 + 6\%)^3$	$ 42,821
		Fair value at initial recognition	*$ 44,654*

- Discounting the interest and principal repayments using the market rate of 6%, Entity A will recognise an originated loan of HK$44,654.
- The difference of HK$ 5,346 is expensed immediately
  - as the expectation about future operating profit of Entity B does not qualify for recognition as an intangible asset.

Initial Recognition & Measurement

Example 26

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?

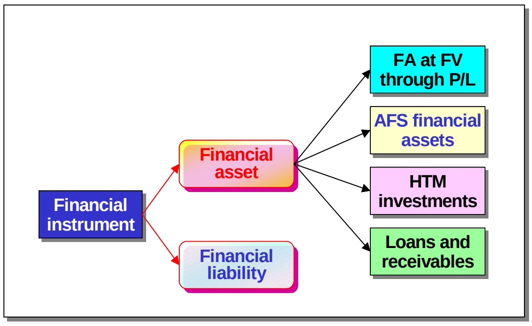
Initial Recognition & Measurement

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?

Financial Assets – Measurement



- **Measurement after recognition**
- **Impairment**
- **Reclassification**

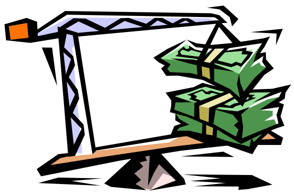
Measurement after Recognition

Classification determine

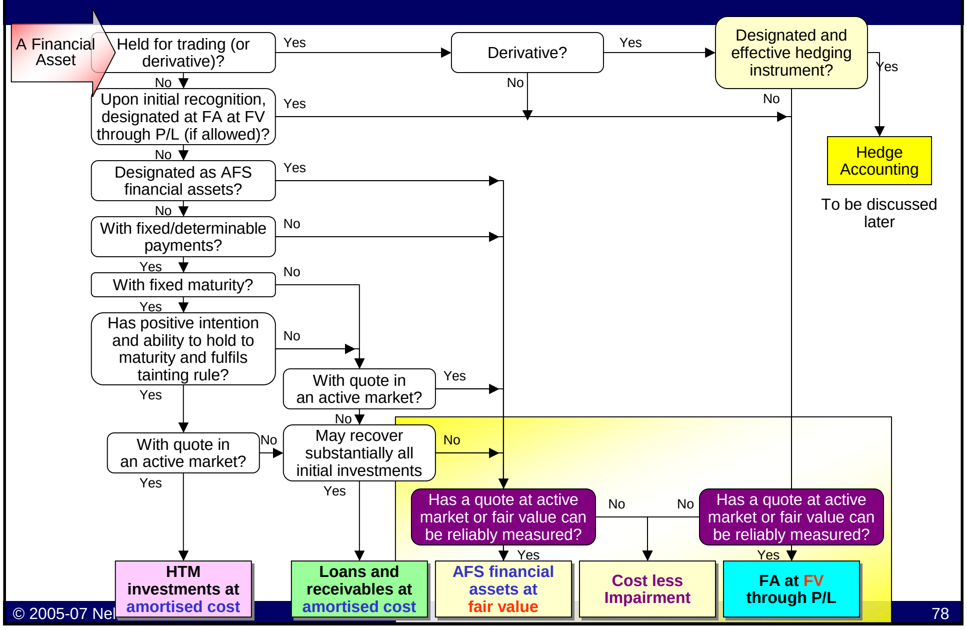
Subsequent Measurement

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

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**



Measurement after Recognition



Measurement after Recognition

Subsequent Measurement

FA at FV through P/L	at Fair Value ⇨ Gain or loss to ⇨ Profit or loss
AFS financial assets	at Fair Value ⇨ Gain or loss to ⇨ Equity at Cost
HTM investments	at Amortised Cost using the effective interest method
Loans and receivables	at Amortised Cost using the effective interest method

Measurement after Recognition

Subsequent Measurement

FA at FV through P/L	at Fair Value ⇨ **Gain or loss** shall be recognised **in profit or loss**
AFS financial assets	at Fair Value ⇨ **Gain or loss** recognised directly **in equity** at Cost
HTM investments	at Amortised Cost
Loans and receivables	at Amortised Cost

- Except for
  - Impairment losses and
  - Foreign exchange gains and losses (financial asset is treated as if it were carried at amortised cost in the foreign currency for translation purpose)
- Cumulative gain or loss recognised directly in equity shall be transferred to profit or loss on derecognition of the financial asset

Measurement after Recognition

- **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.

Active market exists

- A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange and similar entities.
- The existence of published price quotations in an active market is the best evidence of fair value and when they exist they should be used to measure the financial asset (or financial liability)
  - For an asset held (or liability to be issued) → Current bid price
  - For an asset to be acquired (liability held) → Current ask price
  - If the current bid and asking prices not available → Price of most recent transaction

Measurement after Recognition

- **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.

No active market

- An entity establishes fair value by using a valuation technique
- To establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations
- Valuation techniques include
  - Using recent arm's length market transactions between knowledgeable, willing parties
  - Discounted cash flow analysis
  - Option pricing models

- Can NAV of an unlisted entity be considered as fair value?
- It is much like a finance question …… yes & no

Measurement after Recognition

Example 27

Fair Value of Quoted Price

- Financial Controller, Ms. Luk, manages a fund and the rules applicable to the fund require net asset values to be reported to investors on the basis of mid-market prices.
- In these circumstances, would it be appropriate for an investment fund to measure its assets on that basis in the balance sheet of the fund?

No.

- The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in HKAS 39 to use the current bid price in the absence of a matching liability position.
- In its financial statements, an investment fund measures its assets at current bid prices.
- In reporting its net asset value to investors, an investment fund may wish to provide a reconciliation between the fair values recognised on its balance sheet and the prices used for the net asset value calculation.

Measurement after Recognition

Example 28

Block Premium on Quoted Shares

- Entity A holds 15% Entity B's share capital
  - It is publicly traded in an active market with a currently quoted price of $100.
  - Daily trading volume of Entity B's shares is 0.1% of its outstanding shares.
- Entity A believes that the fair value of the Entity B shares it owns, if sold as a block, is greater than the quoted market price
- Entity A obtains several independent estimates of the price it would obtain if it sells its holding.
- These estimates indicate that Entity A would be able to obtain a price of $105, i.e. a 5% premium above the quoted price.
- Which figure should Entity A use for measuring its holding at fair value?

- Under HKAS 39, a published price quotation in an active market is the best estimate of fair value.
- Therefore, Entity A uses the published price quotation ($100).
- Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

Measurement after Recognition

Case 4

Standard Chartered

Accounting policy (from 2005 after the adoption of IFRS):

- 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.

Measurement after Recognition

Case 5

Li & Fung Limited

- In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:
  - The fair values of quoted investments 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,
    - reference to other instruments that are substantially the same,
    - discounted cash flow analysis, and
    - option pricing models refined to reflect the issuer's specific circumstances.

Measurement after Recognition

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**

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
  - Included those derivatives that are linked to and must be settled by delivery of such quoted equity instruments

Measurement after Recognition

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**

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.

Measurement after Recognition

- The effective interest method is a method
  - of calculating the amortised cost of a financial instruments (or group of financial instruments) and
  - of allocating the interest income/expense over the relevant period.
- The effective interest rate is the rate
  - is the rate that exactly discounts estimated future cash payments/receipts through the expected life of the financial instrument or,
  - when appropriate, a shorter period to the net carrying amount of the financial instrument.
- When calculating the effective interest rate,
  - an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses.

Measurement after Recognition

- The calculation includes
  - all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see HKAS 18),
  - transaction costs, and
  - all other premiums or discounts.
- There is a presumption that
  - the cash flows and the expected life of a group of similar financial instruments can be estimated reliably.
- When applying the effective interest method
  - an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument.

Measurement after Recognition

Case 6

Hang Seng Bank *(2004 Annual Report)*

Loan fee income and costs

- The current policy for
  - recognition of loan fee income and servicing cost
    - is set out in note 3(a) above and
  - incentive or rebate on loan origination
    - is charged as interest expense as incurred or amortised over the contractual loan life.
- On adoption of HKAS 39,
  - substantially all loan fee income and directly attributable loan origination costs (including mortgage incentive payments) will be
    - amortised over the expected life of the loan as part of the effective interest calculation.

恒生銀行 HANG SENG BANK

Measurement after Recognition

Example 29

Amortised Cost on Low Interest Loan

- Followed on same previous example, Entity A grants a 3-year loan of HK$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%
- Entity A believes that the future business to be generated with this new customer will lead to a profitable lending relationship.
- On initial recognition, Entity A recognised $47,327 (as calculated below):

	Cash inflow	Discount factor	Present value
31.12.2005	\$ 50,000 x 4% = \$ 2,000	$1 / (1 + 6\%)^1$	\$ 1,887
31.12.2006	\$ 2,000	$1 / (1 + 6\%)^2$	\$ 1,780
31.12.2007	\$ 52,000	$1 / (1 + 6\%)^3$	\$ 43,660
		Fair value at initial recognition	*\$ 47,327*

- Calculate the amortised cost each year end.

Measurement after Recognition

Example 29

	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

- For example, at 31.12.2005, the entry is:

Dr	Loans receivable ($47,327 x 6%)	2,840	
Cr	Interest income (P/L)		2,840
	Being effective interest income recognised for the year.		
Dr	Cash (interest received, $50,000 x 4%)	2,000	
Cr	Loans receivable		2,000
	Being cash interest received.		

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

Conditions for Impairment

- A financial asset (or a group of financial assets) is impaired and impairment losses are incurred if, and only if
  - there is objective evidence of impairment as a result of one or more events
    - that occurred after the initial recognition of the asset (a '**loss event'**) and
    - that loss event (or events) has **an impact on the estimated future cash flows** of the financial asset (or group of financial assets that) can be reliably estimated.
- It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment.
- Losses expected as a result of future events, no matter how likely, are not recognised.

Measurement – Impairment

Outside the scope of HKAS 36

Examples of objective evidence of impairment:

a) significant financial difficulty of the issuer or obligor;

b) a breach of contract, such as a default or delinquency in interest or principal payments;

c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;

d) it becomes probable that the borrower will enter bankruptcy or other financial reorganisation;

e) the disappearance of an active market for that financial asset because of financial difficulties; or

f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

   i) adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments); or

   ii) national or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate or a decrease in property prices the area).

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		
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**

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 – Impairment

Example 30

Amortised Cost on Low Interest Loan

- Followed on same previous example, Entity A grants a 3-year loan of HK$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.

Measurement – Impairment

Example 30

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

Carrying amount (per the balance as at 31.12.2006)	\$ 48,167
Present Value of estimated future cash flows discounted at original effective interest rate as at 2.1.2006	44,500
Impairment loss	\$ 3,667

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

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

Loans and receivables

- The amount of the 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.

Measurement – Impairment

Outside the scope of HKAS 36

FA at FV through P/L — at Fair Value

AFS financial assets — at **Fair Value** ➡

HTM investments

Loans and receivables

Implication?

Impairment (if there is objective evidence)

- 2 conditions to effect impairment loss
  - when a decline in the fair value of an AFS financial asset has been recognised directly in equity and
  - there is objective evidence that the asset is impaired
- Then, the cumulative loss that had been recognised directly in equity shall be
  - removed from equity and
  - recognised in profit or loss

  even the asset has not been derecognised.
- The amount of the cumulative loss that is removed from equity and recognised in profit or loss shall be 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.

Measurement – Impairment

Example 31

Impairment reserves

- In view of the market downturn, Entity C proposes to recognise impairment or bad debt losses in excess of impairment losses that are determined on the basis of objective evidence about impairment in loan receivables from customers.
- Does HKAS 39 permit such recognition?

No.

- HKAS 39 does not permit an entity to recognise impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or identified groups of financial assets with similar credit risk characteristics on the basis of objective evidence about the existence of impairment in those assets.
- Amounts that an entity might want to set aside for additional possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognised as impairment or bad debt losses under HKAS 39.

Measurement – Impairment

Example 32

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.

Measurement – Impairment

Example 33

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.

Measurement – Impairment

Example 34

Impairment on Portfolio Basis

- If one loan in Entity A is impaired but the fair value of another loan in Entity A is above its amortised cost.
- Does HKAS 39 allow non-recognition of the impairment of the first loan?

No.

- If an entity knows that an individual financial asset carried at amortised cost is impaired, HKAS 39 requires that the impairment of that asset should be recognised.
- HKAS 39 states: "the amount of the 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".
- Measurement of impairment on a portfolio basis under HKAS 39 may be applied to groups of small balance items and to financial assets that are individually assessed and found not to be impaired when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

Measurement – Impairment

Example 35

Aggregate Fair Value Less Than Carrying Amount

- HKAS 39 requires that gains and losses arising from changes in fair value on AFS financial assets are recognised directly in equity.
- If the aggregate fair value of such assets is less than their carrying amount, should the aggregate net loss that has been recognised directly in equity be removed from equity and recognised in profit or loss?

Not necessarily.

- The relevant criterion is not whether the aggregate fair value is less than the carrying amount, but whether there is objective evidence that a financial asset or group of assets is impaired.
- An entity assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of assets may be impaired.
- HKAS 39 states that a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.
- Additionally, a decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (e.g. a decline in the fair value of a bond resulting from an increase in the basic risk-free interest rate).

Measurement – Impairment

Case 7

Hang Seng Bank *(2004 Annual Report)*

Provisions for bad and doubtful debts

- The current accounting policy on provisions for bad and doubtful debts is set out in note 3(c) above.
- Note 3(c) states that:
  - It is the Group's policy to make provisions for bad and doubtful debts promptly where required and on a prudent and consistent basis.
  - There are two basic types of provisions, specific and general, each of which is considered in terms of the charge and the amount outstanding.

恒 生 銀 行
HANG SENG BANK

Measurement – Impairment

Case 7

Hang Seng Bank *(2004 Annual Report)*

Provisions for bad and doubtful debts

- On adoption of HKAS 39,
  - Impairment provisions for advances assessed individually are calculated using a discounted cash flow analysis for the impaired advances.
  - Collective assessment of impairment for individually insignificant items or items where no impairment has been identified on an individual basis is made using formula-based approaches or statistical methods.
  - Impairment provisions for advances will be presented as individually assessed and collectively assessed instead of specific provisions and general provisions.
  - There will be no significant change in the net charge for provisions to profit and loss account.

恒 生 銀 行
HANG SENG BANK

Measurement – Impairment

Case 8

Standard Chartered

Accounting policy on impairment of available-for-sale assets (from 2005):

- A significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the assets are impaired.
  - If any such evidence exists for available-for-sale financial assets, the cumulative loss (measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss) is removed from equity and recognised in the income statement.
- Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.
- If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through the income statement.

Measurement – Impairment

Case 9

Li & Fung Limited

2005 Interim Report set out the impairment loss policy as follows:

- The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired.
- In the case of equity securities classified as available for sale, a significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the securities are impaired.
- If any such evidence exists for available-for-sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognized in the consolidated profit and loss account – is removed from equity and recognized in the consolidated profit and loss account.
- Impairment losses recognized in the consolidated profit and loss account on equity instruments are not reversed through the consolidated profit and loss account.

Measurement – Impairment

Outside the scope of HKAS 36

Impairment ← **Is Reversal allowed?**

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 losses on **equity instrument**

– shall **NOT be reversed** through profit or loss.

Impairment losses on **debt instrument**

– If, in a subsequent period
  - the fair value of a debt instrument classified as AFS financial assets increases, and
  - the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss

– Then, the impairment loss shall be reversed, with the amount of the reversal recognised in profit or loss

Measurement – Impairment

Outside the scope of HKAS 36

Impairment ← **Is Reversal allowed?**

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

Such impairment losses shall NOT be reversed

Measurement – Impairment

Outside the scope of HKAS 36

Impairment ← **Is Reversal allowed?**

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**

- If, in a subsequent period
  - 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)
- Then, the previously recognised impairment loss shall be reversed either
  - directly or
  - by adjusting an allowance account.
- The reversal shall 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.
- The amount of the reversal shall be recognised in profit or loss.

Measurement – Reclassification

Reclassification

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**

An entity shall NOT reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.

Measurement – Reclassification

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

Reclassification

A change in intention or ability

- HTM investments shall be
  - reclassified as AFS financial assets
  - re-measured at fair value, and
  - the difference between its carrying amount and fair value shall be recognised directly in equity

Tainting rule triggered

- Any remaining HTM investments shall be reclassified as AFS financial assets.
- On such reclassification, the difference between their carrying amount and fair value shall be recognised directly in equity

Measurement – Reclassification

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

Reclassification

If a reliable measure becomes available on fair value

- the asset shall be re-measured at fair value, and
- the difference between its carrying amount and fair value shall be accounted for depending the classification of such asset as
  - FA at FV through P/L, or
  - AFS financial assets

Measurement – Reclassification

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

Reclassification

- In case of
  - a change in intention or ability
  - in the rare circumstance, a reliable measure of fair value is no longer available, or
  - tainting rule expires
- Then, it becomes appropriate to carry a financial asset at **cost** or **amortised cost** rather than at fair value

Measurement – Reclassification

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

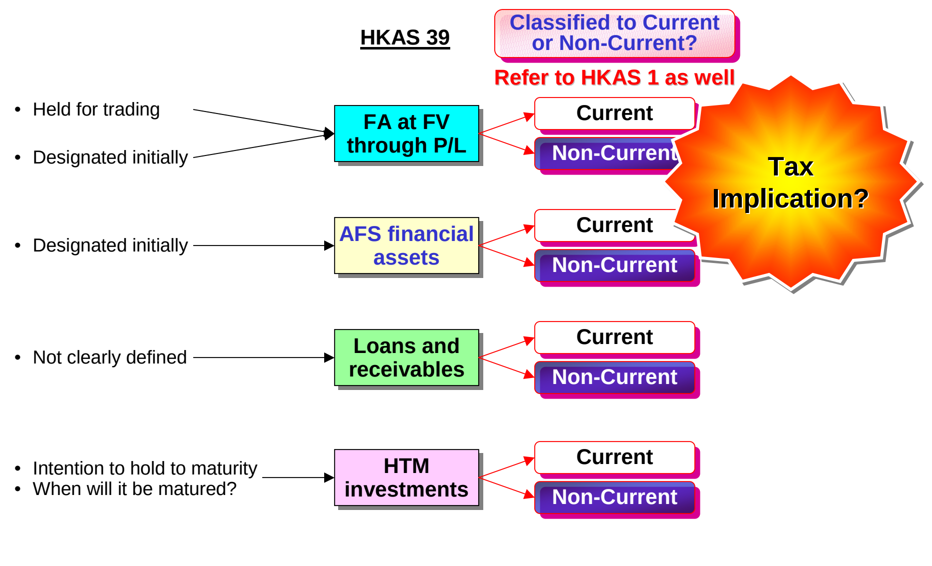
Reclassification

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

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

Measurement – Current or Non-Current



Measurement – Current or Non-Current

Case 10

Li & Fung Limited

- In its 2005 Annual Report, full set of HKFRS was adopted and the report set out that:
  - Available-for-sale financial assets are non-derivatives that are
    - either designated in this category or
    - not classified in any of the other categories.
  - They are included in non-current assets
    - unless management intends to dispose of the investment within 12 months of the balance sheet date.

Is it current?

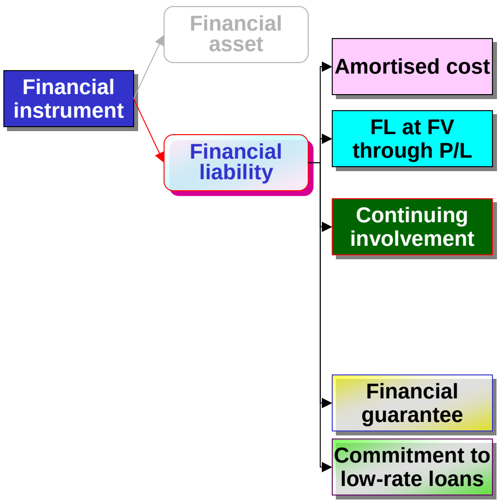
Measurement – Current or Non-Current

- HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* states (HKFRS 5.3) that:
  - Assets classified as non-current in accordance with HKAS 1 *Presentation of Financial Statements* shall not be reclassified as current assets
    - until they meet the criteria to be classified as held for sale in accordance with this HKFRS.
  - Assets of a class that an entity would normally regard as non-current that are acquired exclusively with a view to resale shall not be classified as current
    - unless they meet the criteria to be classified as held for sale in accordance with this HKFRS.
  - They are included in non-current assets
    - unless management intends to dispose of the investment within 12 months of the balance sheet date.

Is it current?

Financial Liabilities – Measurement

Financial Liabilities – Measurement



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

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

Financial Liabilities – Measurement

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.

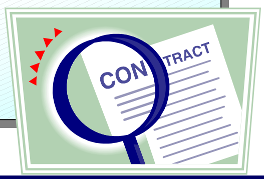
Financial Liabilities – Measurement

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

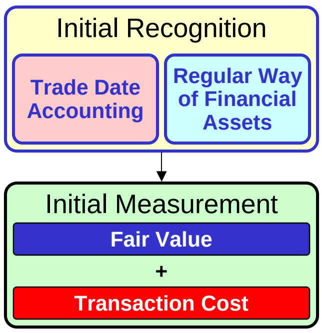


Financial Liabilities – Measurement

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)



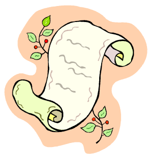
- If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction,
  - its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

Financial Liabilities – Measurement

Financial guarantee

- However, for financial guarantee contracts alone, if the issuer 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 (Insurance Contracts)

    to such financial guarantee contracts.
  - The issuer may make that election contract by contract, but the election for such contract is irrevocable. (HKAS 39.47 and 39.AG4A)



Financial Liabilities – Measurement

Case 11

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

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

Case 12

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 initially recognised at fair value.
  - – 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 12

香港交易所 HKEx

- How did HKEx calculate the fair value 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 13

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 14

Recruit 才庫媒體集團有限公司

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 14

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 14

How much did it have …….

Recruit 才庫媒體集團有限公司

Annual Report 2006 – Note 36 set out:

	Group		Company	
	2006	2005	2006	2005
	HK$'000	HK$'000	HK$'000	HK$'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.

Financial Liabilities – Measurement

Case 14

How much did it have …….

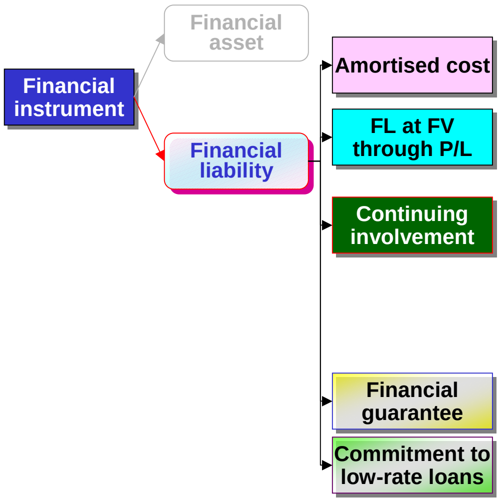
Recruit 才庫媒體集團有限公司

Annual Report 2006 – Note 36 set out:

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



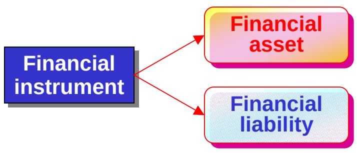
Reclassification

- Similar to financial asset, transfer into or out of financial liabilities at fair value through profit or loss is prohibited while it is held or issued
- Unless, in rare cases, a reliable measure of fair value is no longer available
- Then, it should be carried at amortised cost

Implication

- Reclassification is infrequent or rare

Derecognition



Derecognition of Financial Assets

An entity shall derecognise a **financial asset** when, and only when:

a) the contractual rights to the cash flows from the financial asset expire; or

b) it transfers the financial asset, and the transfer qualifies for derecognition

Direct derecognition

Further Test 1: Asset Transfer Test

Further Test 2: Risk and Reward Test

General principles

- **If passing both Further Tests** ⇒ **derecognise the asset**
- **If not passing Asset Transfer Test** ⇒ **not derecognise the asset**
- **If passing the Asset Transfer Test, but not passing Risk and Reward test** ⇒ **consider the entity's control over the asset, and extent of continuing involvement**

Derecognition of Financial Assets

Consolidate all subsidiaries (including any SPE) [Para. 15]

↓

Determine whether the derecognition principles below are applied to a part or all of an asset (or group of similar assets) [Para. 16]

↓

Have the rights to the cash flows from the asset expired? [Para. 17(a)] — Yes → **Derecognise the asset**

↓ No

Has the entity transferred its rights to receive the cash flows from the asset? [Para. 18(a)] — Yes → (to Para. 20(a))

↓ No

Has the entity assumed an obligation to pay the cash flows from the asset that meets the conditions in paragraph 19? [Para. 18(b)] — No → **Continue to recognise the asset**

↓ Yes

Has the entity transferred substantially all risks and rewards [Para. 20(a)] — Yes → **Derecognise the asset**

↓ No

Has the entity retained substantially all risks and rewards? [Para. 20(b)] — Yes → **Continue to recognise the asset**

↓ No

Has the entity retained control of the asset? [Para. 20(c)] — No → **Derecognise the asset**

↓ Yes

Continue to recognise the asset to the extent of the entity's continuing involvement

Derecognition of Financial Assets

Example 36

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

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

Has the entity <u>transferred substantially all risks and rewards</u> [Para. 20(a)]

Has the entity <u>retained substantially all risks and rewards</u>? [Para. 20(b)]

Derecognition of Financial Assets

- If a transfer does <u>not result in derecognition</u> because the entity has <u>retained substantially all the risks and rewards of ownership</u> of the transferred asset, the entity shall
  - continue to recognise the transferred asset in its entirety
  - recognise a financial liability for the consideration received
  - in subsequent periods, recognise
    - any income on the transferred asset and
    - any expense incurred on the financial liability.

Has the entity <u>retained substantially all risks and rewards</u>? [Para. 20(b)] → Yes → **Continue to recognise the asset** → Consideration received → **Recognise (create) a financial liability**

Derecognition of Financial Assets

Example 37

For SMEs/SMPs ⇒ say Discounted Bills, Factored Trade Receivables
For larger entities ⇒ say Strip and Total return swap

Let's analyse a bill discounted to bank
⇒ At present, most entities derecognise bill receivable discounted to bank and disclose it as contingent liability
⇒ Is it appropriate under new derecognition criteria?

The contractual rights to receive the asset's cash flows are transferred

If the debtor is default on the payment, the entity has to repay the bank ⇒ risks are retained by the entity

Continue to recognise the bill receivables, and recognise a financial liability

Derecognition of Financial Assets

Case 15

Li & Fung Limited

- In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:
  - the Group's discounted bills with recourse,
    - which were previously treated as contingent liabilities,
    - have been accounted for as collateralized bank advances prospectively on or after 1 January 2005,
    - as the financial asset derecognition conditions as stipulated in HKAS 39 have not been fulfilled.

Total advances recognised:	HK$ 822M
Current liabilities of that date:	7,578M
Net current assets of that date:	1,229M

Derecognition of Financial Assets

Case 16

2005/06 Annual Report:

- HKSA 39 provides more rigorous criteria for the derecognition of financial assets than the criteria applied in previous years.
- Under HKAS 39, a financial asset is derecognised, when and only when, either the contractual rights to the asset's cash flows expire, or the asset is transferred and the transfer qualifies for derecognition in accordance with HKAS 39. The decision as to whether a transfer qualifies for derecognition is made by applying a combination of risks and rewards and control tests ……
- The Company has applied the relevant transitional provision ……
- As a result, the Company's credit card receivables transferred to a special purpose entity under asset securitisation, which were derecognised prior to 20th February 2005, have not been restated.
- Any new transfer of credit card receivables to the SPE after 21st February 2005 has not been derecognised and remained as credit card receivables in the Company's financial statements.
  - This has resulted in a decrease in credit card securitisation income of HK$23,700,000 in the current year.

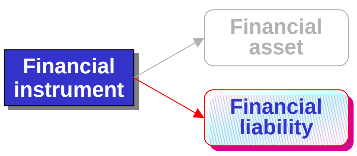
Credit card receivable ↑ 106%

Turnover ↑ 4%

Derecognition of Financial Liability

- An entity shall derecognise a financial liability (or part of a financial liability) when, and only when, it is extinguished
  i.e. obligation discharged or cancelled or expires
- An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as
  - an extinguishment of the original financial liability and
  - the recognition of a **NEW** financial liability.
- Similar accounting treatment is adopted for a substantial modification of the terms of an existing financial liability or a part of it
- The difference between
  - the carrying amount of a financial liability extinguished or transferred to another party and
  - the consideration paid, including any non-cash assets transferred or liabilities assumed

  shall be recognised in profit or loss.



HKAS 39 Workshop

21 April 2007

Full set of slides in PDF may be found in
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