FINANCIAL INSTRUMENTS

Structure of the discussion

Section I

- Classification, measurement and recognition

Section II

- Derivatives

Section III

- Guarantees and De-recognition

Section IV

- Hedge accounting

Section V

- Presentation

Section VI

- Disclosure

Section I

Key terms

IFRS

Financial Instrument: A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial Asset: Any asset that is:

- Cash
- Equity instrument of another entity
- Contractual right to receive cash/ another financial asset or exchange financial assets /liabilities under conditions that are favorable to the entity
- A contract that will or may be settled in the entity's own equity instruments

Financial Liability: Any liability that is:

- A contractual obligation to deliver cash or another financial asset or exchange financial assets /liabilities under conditions that are unfavorable to the entity
- A contract that will or may be settled in the entity's equity instruments

Equity Instrument: Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities

Fair Value: The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction

Case study

IFRS

Entity A holds an option to purchase equity shares in a listed entity B for Rs 5 per share at the end of 90 day period.

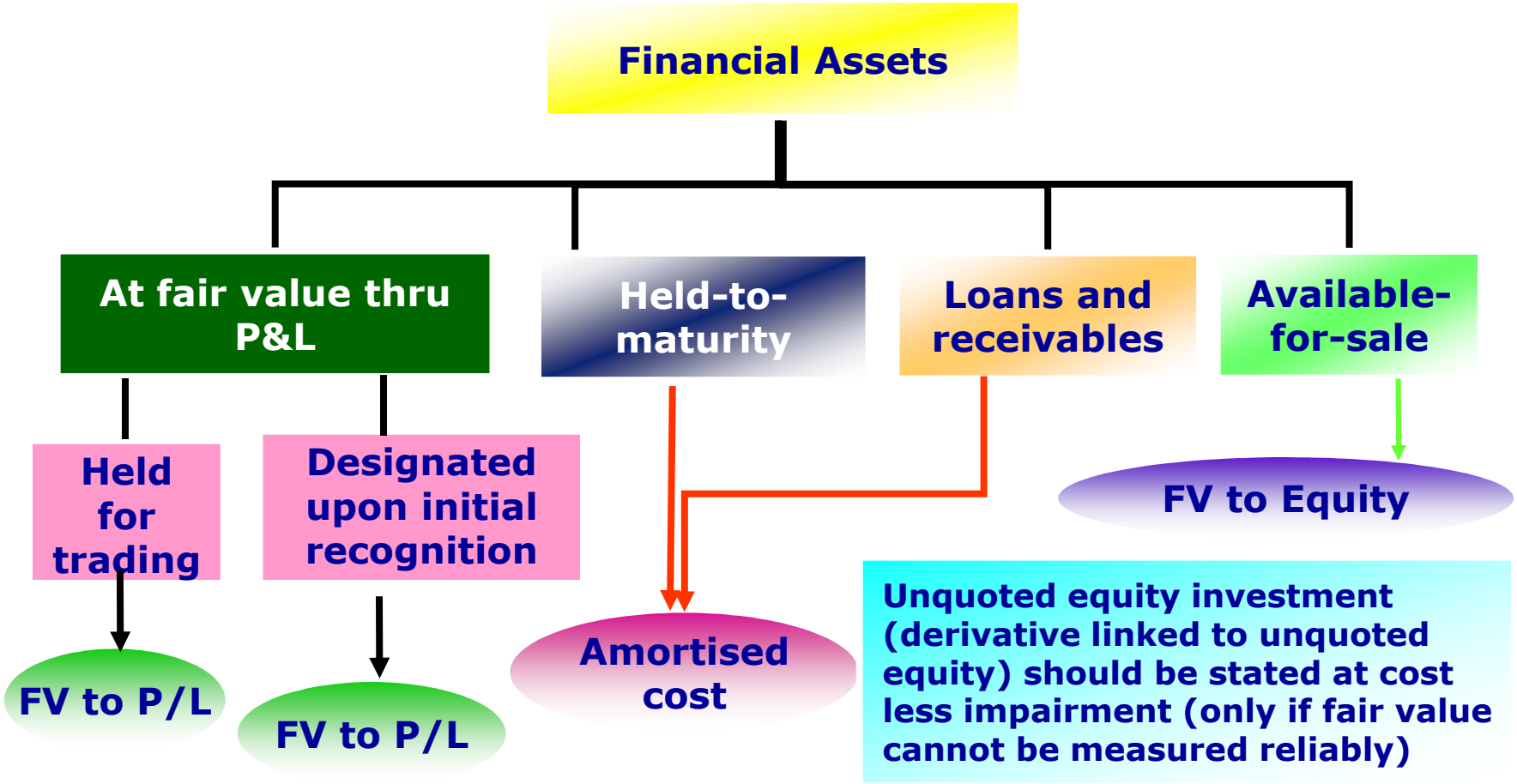
Option is derivative financial assets – From A's perspective

If Entity A writes an option under which the counterparty can force the entity to sell equity shares in the listed entity B for Rs 5 per share at any time in the next 90 days.

Option is a derivative financial liability – from A's perspective

Classification of financial assets

IFRS



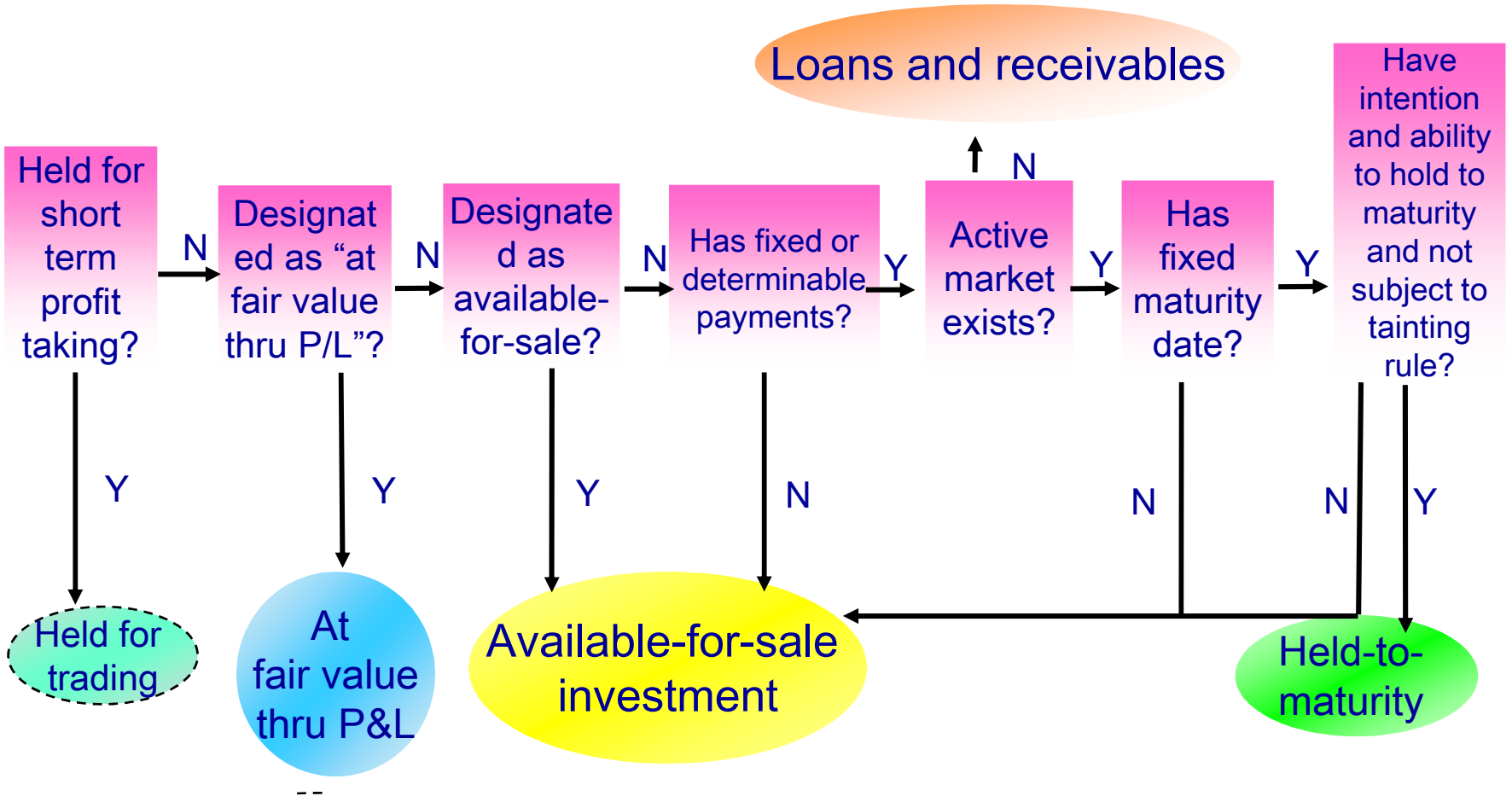
Overview of classification and measurement requirements

IFRS

Category	Criteria for Designation	Measurement	Impairment to
Fair Value through P&L	Trading , derivatives plus “fair value option”	FV to P&L	P&L
Available-for- Sale	Free designation except for trading and derivatives	FV to equity	Equity surplus and then P&L, no reversal thru P/L for equity instruments
Loans and Receivables	Must meet definition, cannot be quoted in an active market	Amortised cost	P&L
Held-to-Maturity	Must meet definition and have intention and ability, subject to “tainting rule”	Amortised cost	P&L

Classification of financial assets: decision tree

IFRS



Financial assets: Held for trading

IFRS

Acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

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

Derivatives unless an effective hedging instrument

Quiz

Company A has recently purchased some quoted and unquoted equity shares (fair value not reliably measurable). Company A has designated these as held for trading. Historically, Company A always purchased shares when it had surplus cash. There is no pattern of frequent buying and selling.

Financial assets: Designated at Fair Value Through P&L

Criteria:

(i) Eliminates or significantly reduces accounting mismatch arising from measuring asset and liabilities, and gains and loss using different measurement bases.

Example:

An entity has a fixed rate debt. It enters into an interest swap to receive fixed and pay variable interest. The interest swap is a derivative fair valued through profit or loss. The entity does not wish to apply fair value hedge accounting due to onerous documentation requirements.

In order to achieve a natural hedge, the entity on initial recognition can designate the debt at fair value through profit or loss

IFRS

Financial assets: Designated at Fair Value Through P&L

Criteria:

(ii) Financial assets or liabilities or both managed and performance evaluated on a fair value basis in accordance with documented risk management strategy or investment strategy. Information on these assets are internally provided to key management personnel on a fair value basis.

Example:

Venture capitalists

Quiz

If a venture capitalist owns 60% and 26% interest in two different entities, will the above fair value option permit not to consolidate and equity account the 60% and 20% interests?

IFRS

Financial assets: Designated at Fair Value Through P&L

IFRS

Criteria:

(iii) Contracts containing one or more embedded that are not clearly and closely related.

Example:

(i) A debt instrument whose interest is linked to a commodity index

(ii) Prepayment option on a loan where amount prepaid will approximate the amortized cost.

Which of these can be designated at fair value through profit or loss?

(i) as interest not clearly and closely related to host contract

Financial assets: Held-to-Maturity

IFRS

Financial Instruments with fixed or determinable payments and fixed maturity.

There must be positive intent and ability to hold the securities until maturity.

Fixed or determinable = contractual arrangement defines the amounts and date of interest and principal payments

Quiz

Company A buys a 10% ownership interest in C Ltd. Company A has intent and the ability to hold the ownership interest for long-term. The ownership interest is repayable by C Ltd only on liquidation.

What should Company A classify the ownership as?

Financial assets: Held-to-Maturity

IFRS

Quiz

G Ltd has subscribed to a bond with interest payments indexed to the price of gold. The bond has a fixed payment at maturity and a fixed date.

Accounting for the bond?

Financial assets: Held-to-Maturity

IFRS

Positive Intent and Ability to Hold to Maturity

Classification as held-to-maturity ("HTM') means that the holder is indifferent to future profits from changes in fair value.

Example:

X Ltd has a portfolio of debt instruments it wishes to classify as HTM. X Ltd investment policy allows management to transfer from HTM to available-for-sale at a specific pre-determined date prior to maturity.

X Ltd cannot classify the debt instruments as HTM as it does not have the positive intent to hold till maturity.

Financial assets: Held-to-Maturity Tainting Rules

IFRS

Tainting is the effect on the remaining HTM securities if some of these are sold before maturity. Tainting rule applies to the consolidated entity. If one subsidiary is tainted, the entire Group's HTM portfolio is tainted.

If there is sale before maturity, the entire portfolio is transferred as available for sale securities. The entity is prohibited for the next two financial years to classify any investment as HTM.

Effect of tainting:

HTM is carried at amortized cost. On transfer as Available-for-sale security it will be carried at fair value with changes recognized in equity. Impairment loss will be recognized in profit or loss.

Financial assets: Held-to-Maturity Tainting Rules

IFRS

Examples of HTM sales which do not attract tainting rules:

(A) Sales close to maturity as any interest movement in remaining period will not be expected to have significant effect on fair value;

(B) Sales once substantially all of the principal has been recovered

(C) Isolated events beyond the holder's control and could not have been reasonably anticipated:

- change in tax laws
- change in regulatory capital requirements

(D) Do not involve 'more than insignificant' amount of entity's total HTM portfolio

Financial assets : Loans and receivables

IFRS

Financial assets with fixed or determinable payments that are not quoted in an active market, other than:

classified as held for trading;

designated as fair value thru P&L; or

classified as available for sale

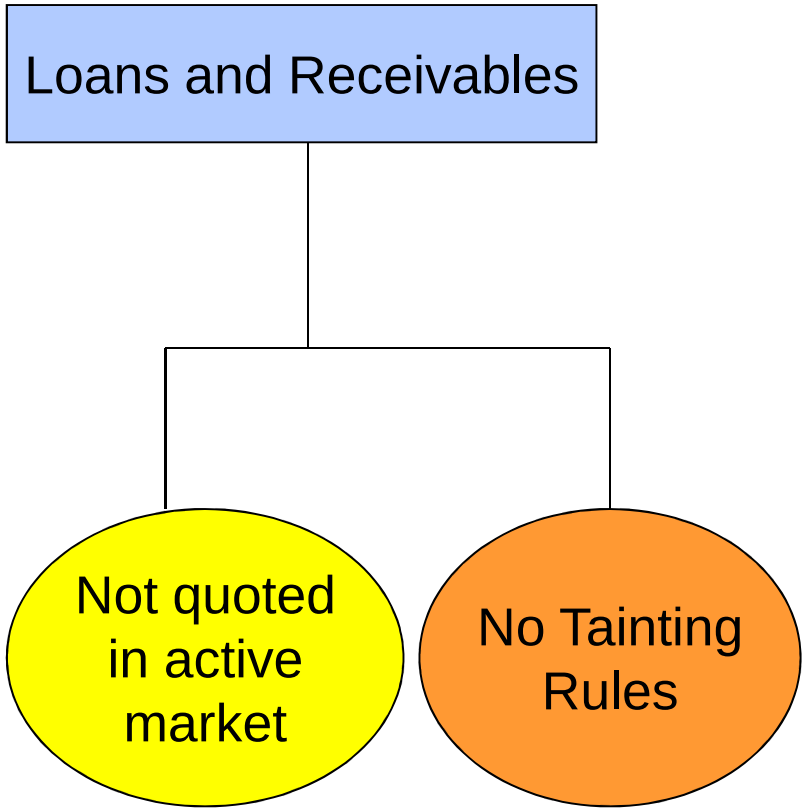
Quiz

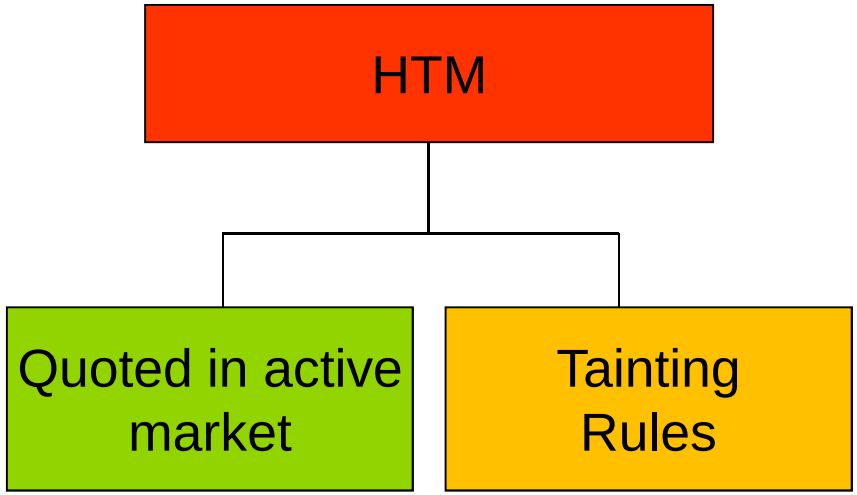
N Ltd purchased mandatorily redeemable preferred shares from M Ltd. The shares are redeemable in three years. M Ltd is listed on BSE.

The preferred shares have been privately placed with N Ltd. N Ltd has the positive intent and hold these shares till redemption.

Classification by N Ltd?

Financial assets : Loans and receivables Versus HTM Securities

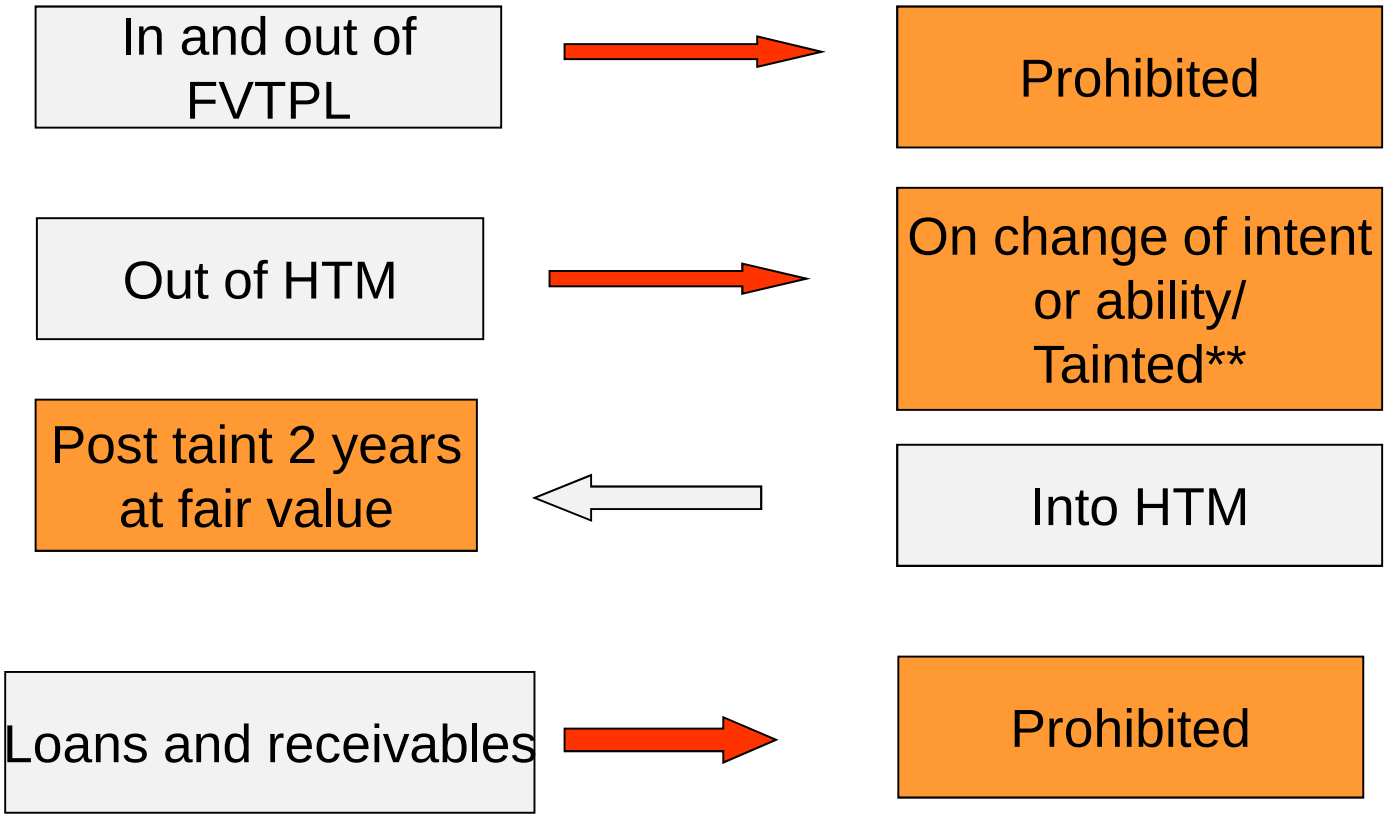




IFRS

Financial assets : Reclassifications between categories

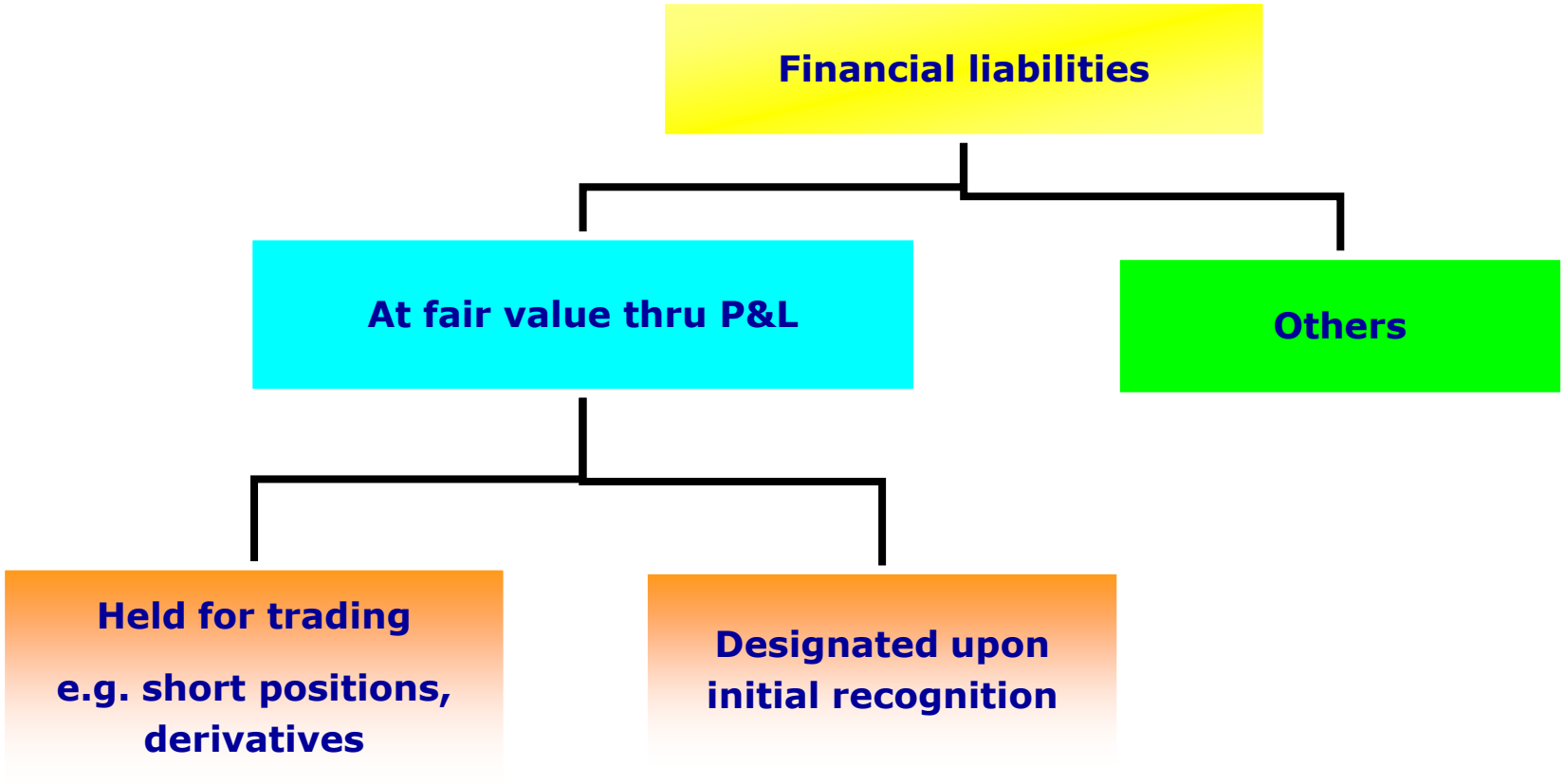
IFRS



*** At fair value with difference compared to amortized cost recognized in equity*

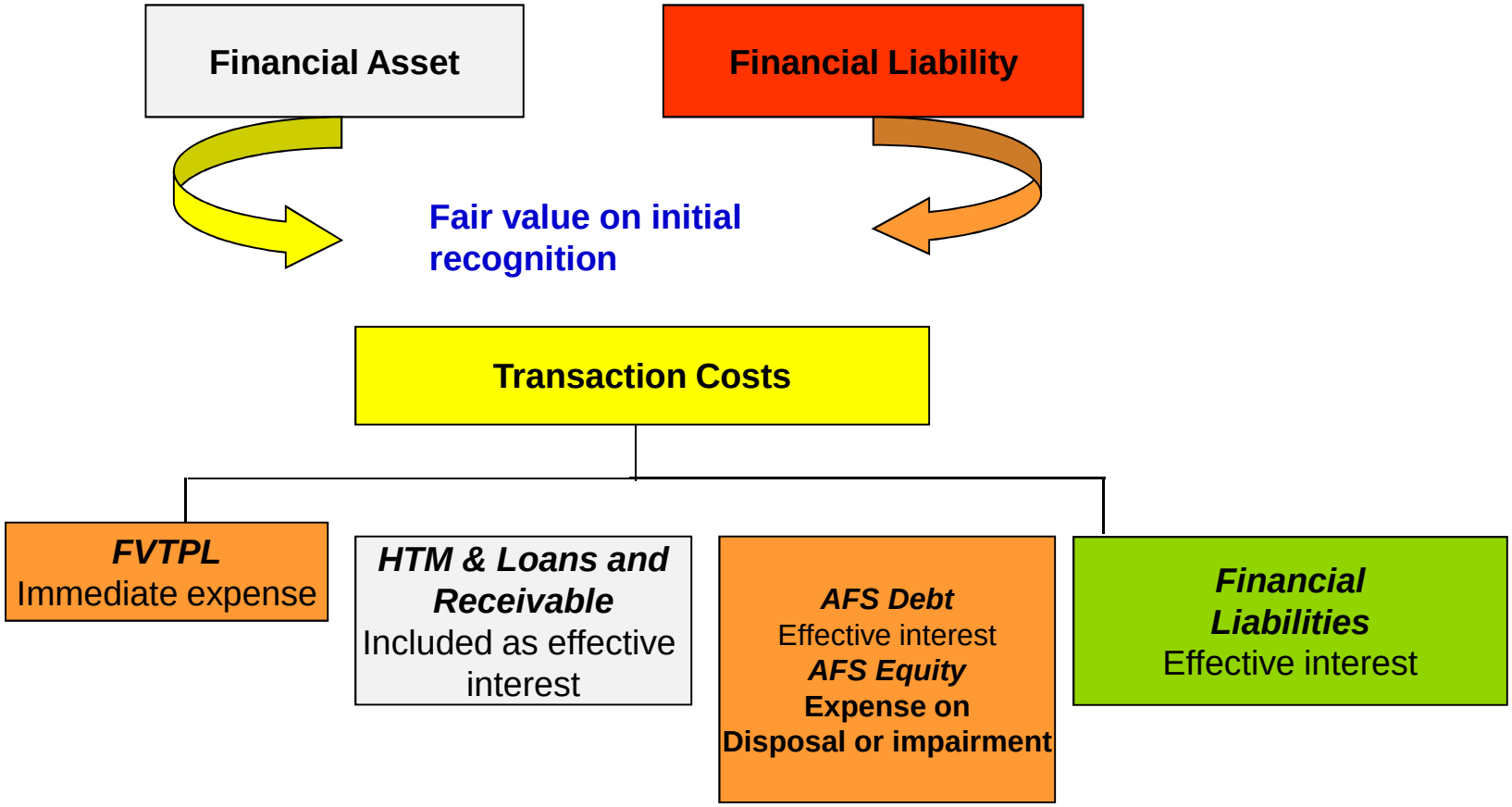
Classification: Financial liabilities

IFRS



Initial Measurement

IFRS



Initial Measurement

IFRS

The fair value of a financial instrument on initial recognition is normally the transaction price.

However, if part of the consideration given or received is for something other than the financial instrument or the transaction was not transacted at arm's length, the fair value is estimated using a valuation technique.

Quiz

Accounting for low-cost employee loan?

IFRS

Initial Measurement

The fair value of a long-term loan that carried no interest can be estimated at the PV of all future cash receipts discounted using the prevailing market rate of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating

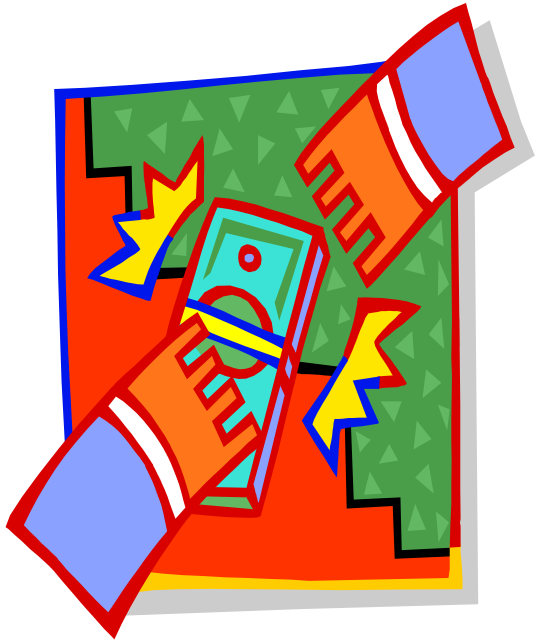
The fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid

What is fair value?

IFRS

Fair value:

Amount for which an asset could be exchanged, or liability settled, between knowledgeable, willing parties in an arms length transaction



What is fair value?

IFRS

Fair value hierarchy:

Best: Published price quotation in active market
- Bid price for asset held or liability to be issued
- Asked price for asset to be acquired or liability held

If no bid/asked prices, look to most recent transaction price

What is fair value?

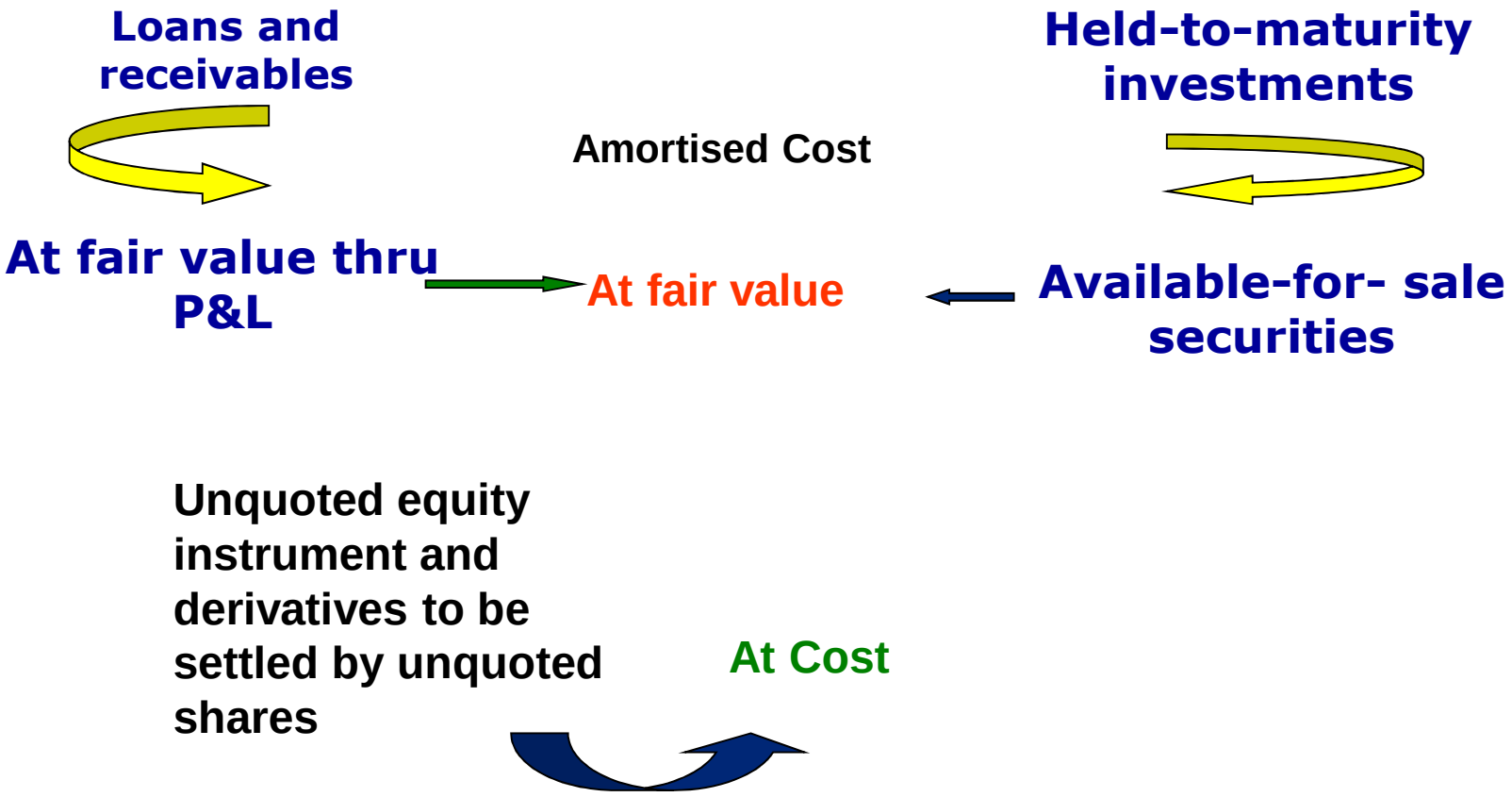
IFRS

If no active market: Use a valuation technique.

- Incorporate all factors that market participants would consider in setting a price
- Acceptable economic pricing methodologies
- Base on observable market data and conditions to the extent possible

Subsequent measurement: Financial assets

IFRS



Subsequent measurement : Amortized cost

IFRS

Applicable to “Held-to-Maturity” and “Loans and Receivables”

Amortized cost is:

Initial cost **-** Principal repayments **+/-** **Cumulative** amortisation of difference between initial amount and maturity amount **-** Write-down for impairment or uncollectibility

Measurement: Calculation of amortized cost of financial asset

IFRS

Amortized cost is calculated using the effective interest method.

The effective interest rate inherent in a financial instrument is the rate that exactly discounts the cash flows associated with the financial instrument through maturity to the net carrying amount at initial recognition. The computation includes all fees and points paid or received.

Measurement: Calculation of amortized cost of financial asset

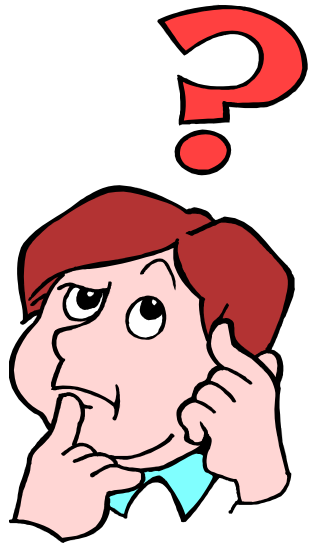
IFRS

Background

Company A purchased a debt instrument with five years remaining to maturity for its fair value of CU 1,000 (including transaction costs). The instrument has a principal amount of CU 1,250 and carries a fixed interest of 4.7% that is paid annually. Company A intends to hold the instrument till maturity

Question

Financial assets that are excluded from fair valuation and that have a fixed maturity should be measured at amortized cost. Since Company A intends to hold the debt instrument till maturity, how is its amortized cost calculated?



Effective interest method

IFRS

$$\text{Initial value} = \frac{\text{Cash flow } Y_0}{(1+r)} + \frac{\text{Cash flow } Y_1}{(1+r)^1} + ... \frac{\text{Cash flow } Y_n}{(1+r)^n}$$

$1000 = 59/(1+r)^{t1} + 59/(1+r)^{t2} + 59/(1+r)^{t3}$
$+ \ldots + [1250 + 59]/(1+r)^{tn}$

r = 10%

Effective interest rate

Interest payment:

1,250 x 4.7%

Repayment of principal

Measurement: Calculation of amortized cost of financial asset

IFRS

ANSWER

With reference to the table below, in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10% annually

Year	At beginning of the year	Interest income (at 10%)	Cash inflows (at 4.7%)	At end of the year
2000	1,000	100	(59)	1,041
2001	1,041	104	(59)	1,086
2002	1,086	109	(59)	1,136
2003	1,136	113	(59)	1,190
2004	1,190	119	(1,250 + 59)	0

Subsequent measurement: Exception from fair value requirement

Presumption:

Fair value can be reliably determined for most financial assets classified as available for sale or held for trading

But:

Presumption can be overcome for:

an investment in an equity instrument that does not have a quoted market price in an active market and for which other methods of estimating fair value are clearly inappropriate / unworkable derivatives linked to and settled by delivery of such investment

IFRS

Subsequent measurement: Impairment

IFRS

At each balance sheet date, the entity should assess whether there is any objective evidence of impairment (eg. financial difficulty of issuer, breach of contract, historical pattern of non-collectibility etc)

(Note: A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment (IAS 39.61)

If any evidence exists, the entity should provide for any impairment to recoverable amount for financial assets measured at amortized costs

i.e. the present value of expected future cash flows discounted at the financial instrument's original effective interest rate

AFS: different rules

Subsequent measurement: Recognition of income impaired assets

IFRS

Question

Company A assesses a CU$10m loan repayable in 2 years and concludes that interest (due at 10% per annum) will not be paid but anticipates repayment of principal on due date.

How does it account for the loan?

Answer

Firstly, it determines the expected future cash flows from the loan, taking into account the probability of future interest / principal repayments, and discounts those cash flows back to the present day using the original effective interest rate

Secondly, it recognises interest income over the remaining life of the loan by unwinding the discount. Any further adjustments to expected cash flows are made by increasing/decreasing provision for impairment

Subsequent measurement: Recognition of income on impaired assets

Step 1	
Discounting the principal to present value at 10%	= $8,265K
Thus	
Carrying amount of:	
- receivable (impaired)	= $8,265K
- impairment loss	= $1,735K ($10,000K - $8,265K)

IFRS

Subsequent measurement: Recognition of income on impaired assets

Step 2
Interest income in first year, at 10% = $8,265K x 10% = $826.5K
Interest income in second year, at 10% = $(8,265K + 826.5K) x 10% = $909K

IFRS

Subsequent measurement: Recognition of income on impaired assets

IFRS

Date	Carrying amount before adjustment	Impairment loss	Interest income accrued	Carrying amount after adjustment
At 01 Jan 20X1	10,000.0	(1,735.0)	-	8,265.0
At 31 Dec 20X1	8,265.0	-	826.0	9,091.0
At 31 Dec 20X2	9,091.0	-	909.0	10,000.0
		(1,735.0)	1,735.0	

The net P&L effect is nil. However, it would affect the allocation of profit and loss over the periods (i.e. recognizing loss at the beginning of the year and recognizing interest income subsequently)

Subsequent measurement: Reversal of impairment loss

Loans and receivables and HTM investments:

- If amount of impairment decreases due to an event occurring after original recognition, reverse through P&L
- But reversal must not increase carrying amount above what amortised cost would have been at reversal date

AFS debt instruments:

- If amount of impairment decreases due to an event occurring after original recognition, reverse through P&L

AFS equity instruments:

- Subsequent increases in fair value result in "reversal" through equity

Impairment loss for financial assets carried at cost (unquoted equity) should not be reversed

IFRS

Subsequent measurement: Impairment

IFRS

Available-for-Sale Equity Instrument

Year 20X1 Purchased: $50 Available-for-Sale investment	Year 20X2 Fair value: $60 Equity: $10	Year 20X3 Fair value: $40 Impairment loss (P&L): $10 Equity: nil	Year 20X4 Fair value: $55 Equity: $15

Note: Any cumulative increase in fair value must be recognized in equity, the reversal of impairment loss is not recognized in P&L

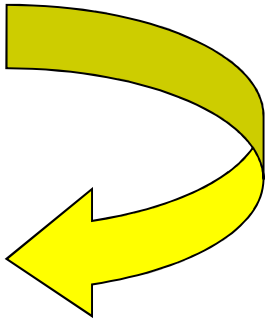
Subsequent measurement: Financial liabilities

IFRS

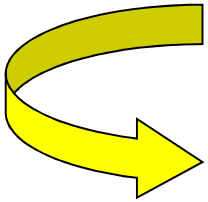
All derivative liabilities except those linked to Unquoted investments

Those designated at FVPTL

at fair value



at amortised cost



All other financial liabilities
(eg. trade payable, bank loan)

IFRS

Section II - Derivatives

Definition of Derivative

IFRS

A derivative is a financial instrument/or other contract:

a. whose value changes in response to the change in a specified interest rate, commodity price, other variable , provided in case of non-financial variable that the variable is not specific to a party to the contract (underlying);

b. that 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 the similar response to changes in market factors; AND

c. that is settled at a future date

Definition of Derivative… Contd

IFRS

Underlying Derivative instrument	Underlying
Interest rate swap	Interest rate index
Commodity forward	Commodity price
Currency swap	Exchange rate
Cross –currency interest rate swap	Exchange rate and interest rate index

Underlying is a variable whose changes are observable or objectively verifiable.

Interaction of the notional amount and the underlying determines the settlement amount of a derivative. Alternatively, a derivative can contain a “payment provision” that is unrelated to a notional amount.

Definition of Derivative… Contd

IFRS

Case study:

Company X, a Rupee functional currency entity, sells products in the US. The sales are denominated in US dollars. Company X enters into a contract with an investment bank to convert US dollars to Rupees at a fixed exchange rate. The contract requires Company X to remit US dollars based on its sales volume in the US in exchange for Rupees at a fixed exchange rate of Rs.40.50.

Two underlying: Foreign exchange rate and volume of sales.

The contract does not have a specified notional amount or a fixed payment provision, but still meets the definition of a derivative

Case study:

Entity ABC receives Rs 100 million if the share price of Entity XYZ increases by more than 5 % during a six month period, but pays Rs Rs 100 million if the share price decreases by more than 5% during the same six month period. No payment is made if the share price is less than 5% up or down.

Underlying: Share price of XYZ

Notional amount: None

Settlement calculation: Payment provision determines the settlement amount

Definition of Derivative… Contd

IFRS

Notional amounts and payments provisions

Case study :

XYZ enters into an interest rate swap that requires XYZ to pay a fixed rate of interest and receive a variable rate of interest. The fixed interest rate amount is 7.5 per cent, while the variable interest rate amount is three-month LIBOR, reset on a quarterly basis. The notional amount of the swap is Rs.100 million.

Underlying: Interest rate Index – LIBOR

Notional: Rs 100 million

Calculation of net settlement: (7.5%- three month LIBOR) * 100 Million.

Definition of Derivative… Contd

IFRS

Initial net investment

If the option premium is so deep in-the- money that the premium paid is close to making an investment in the underlying, then the option contract will fail to meet this criterion. In that situation, the instrument is accounted as an investment in the underlying and not as derivative.

Case study

Company A purchases, for Rs. 1.1 million, an option to buy 80,000 shares in Company B at Rs.75 per share in three months' time. When it purchased The option, Company B's shares were trading at Rs.70 per share.

Initial net investment: Rs. 1.1 million

Cost to buy 80,000 shares : Rs 5.6 million

Initial net investment criterion : Met

Definition of Derivative… Contd

IFRS

Initial net investment

Case study

Entity XYZ purchases a deep-in-the-money call option on Entity ABC shares. ABC's share price is Rs100 per share. The option is an American option with a 180-day maturity. The option has a strike price of Rs10 per share and XYZ pays a premium of Rs. 91.

The initial investment in the option of Rs. 91 is less than the notional amount applied to the underlying, i.e. Rs.100 (the notional amount is one share and the underlying is Rs100 per share).

Net initial investment criterion – met

Case study

Entity X enters into a three-year currency swap with Bank Z. At inception, when the Sterling/Euro exchange rate is 1.5, the swap results in Entity X paying Bank Z £100 million and Bank Z paying Entity X €150 million

Net initial investment criterion – met

Definition of Derivative… Contd

IFRS

Initial net investment

Case study

Entity X enters into an eight-year pay-fixed at 7 per cent, receive LIBOR interest rate swap on CU100 million. It prepays the fixed leg at inception. The amount it pays is calculated as CU7 million (CU100 million x 7 per cent) for 8 years, discounted at market rates.

Initial net investment criterion: Met

Case study

Entity A enters into a six-year pay LIBOR, receive-fixed 5 per cent interest rate swap on CU100 million. It prepays the variable leg at inception. The cash inflows that the entity continues to receive are akin to those of a financial instrument with a fixed annuity of 5 per cent per year for the next six years.

Initial net investment criterion: Not met

Definition of Derivative… Contd

IFRS

Initial net investment

Entity XYZ enters into a contract to purchase 1 million entity T's ordinary shares in one year. The current market price of Entity T's shares is Rs 50 per share; forward price is Rs 55 per share.XYZ is required to prepay the forward contract at inception with a Rs 50 million payment.

Underlying: Share price

Initial net investment: Equals the cost of purchasing 1 million shares at the current price. Hence, criterion not met.

Investment is a "Non derivative financial asset".

Settlement at a future date:

Can be settled net in cash or gross in cash / other financial asset

An option is settled upon exercise or at maturity.

Definition of Derivative… Contd

IFRS

Non derivative contracts to be combined for accounting when they are :

entered into at the same time, and in contemplation of each other;

have the same counterparty;

relate to the same risk; and

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.

Case study:

Entity A makes a five-year fixed rate loan to Entity B on market terms. Simultaneously, Entity B makes a five-year variable rate loan to Entity A on market terms over the same notional.

The combination of these two loans is akin to an interest rate swap. Entire arrangement is accounted for as a derivative.

Definition of Derivative… Contd

IFRS

IAS 39 should be applied to contract to buy /sell a non financial item that can be settled net (either in cash or another financial instrument) with the exception of contracts that are entered into and continue to be held for the purpose of the receipt/delivery of non-financial item in accordance with the entity's expected purchase, sales or usage requirements.

Ways to settle net in cash or another financial instrument include:

When contract permits to do so;

Settlement not explicit, but the entity has a past practice of net settling similar contracts;

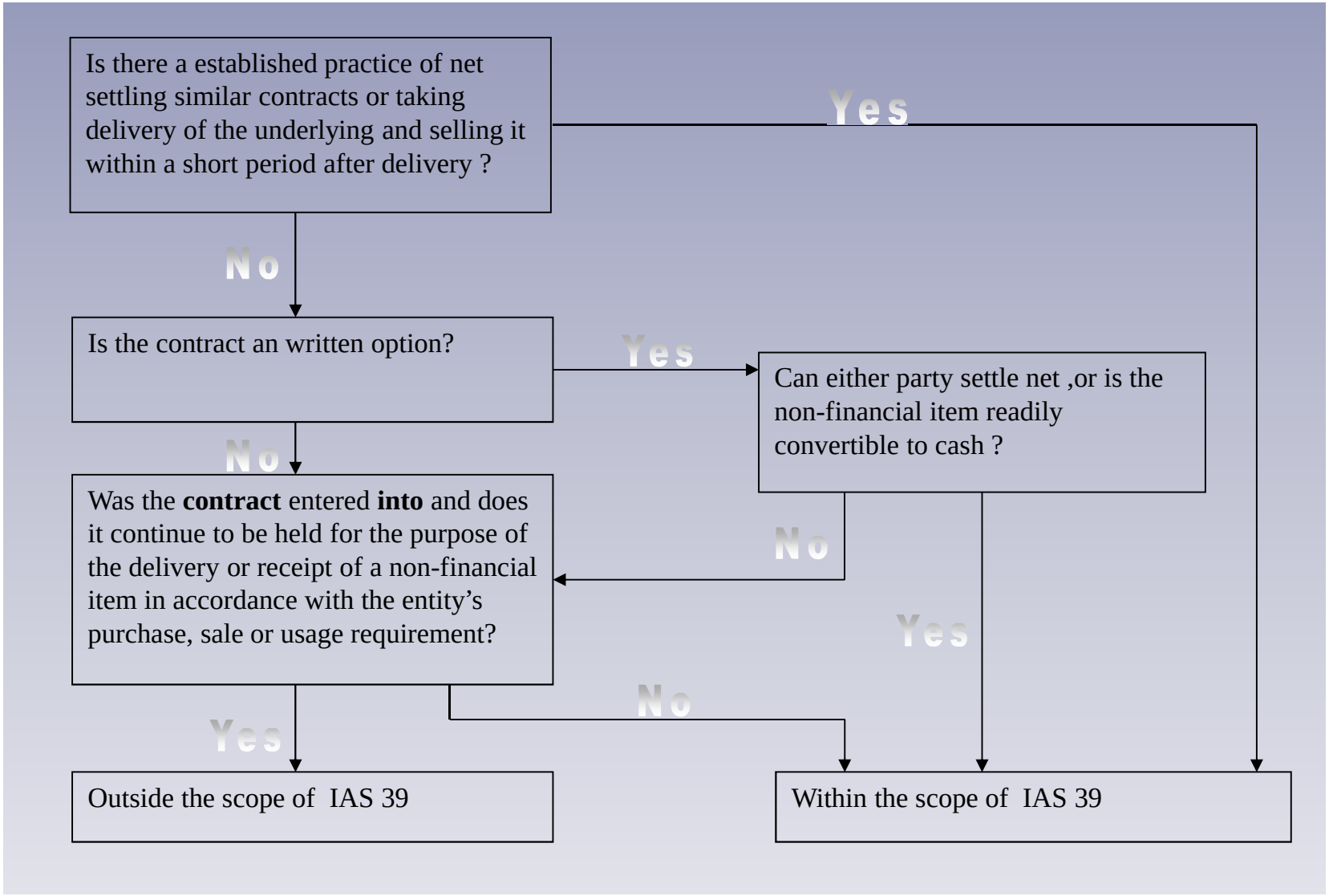
Past practice of taking delivery of the underlying and selling immediately for making profit on short-term price change

Non-financial item is readily convertible into cash

Definition of Derivative… Contd

IFRS

Evaluation steps - whether contracts to buy or sell non-financial items are within the scope of IAS 39



Definition of Derivative… Contd

IFRS

Implicit net settlement - Amount of non performance penalty calculated with reference to the price of the item that is subject to the contract.

Case study:

Entity A enters into a forward purchase agreement with Entity B to buy 100 units of a commodity at CU1.00 per unit. Entity A defaults on the forward when the prevailing market price of the commodity is CU0.75 per unit. Under the non-performance penalty provisions incorporated into the contract, Entity A has to pay Entity B a penalty of CU25, i.e. 100 x (CU1.00 – CU0.75).

The non-performance penalty represents an implicit net settlement provision.

Definition of Derivative

IFRS

Fixed penalty does not amount to net settlement provision

Case study :

Entity A enters into a contract to purchase wheat, which will be used in its manufacturing operations. The delivery contract requires a non-performance penalty of CU1 million if A fails to take delivery of the wheat.

This is a fixed penalty and does not provide for net settlement because the CU1 million payment amount is not based on changes in the price of wheat (the reference asset).

Definition of Derivative

IFRS

Past practice

Case study:

Entity A is a copper manufacturer. Entity A enters into forward contracts to sell its copper cathode to its customers. The forward contracts are homogenous and permit the entity to provide physical delivery or pay or receive a net settlement in cash based on the change in fair value of copper.

Based on its inventory levels and its production capacity, Entity A is able to meet the obligation to deliver copper should it decide to provide physical delivery of copper relating to all of its outstanding forward sales contracts.

Management claims that the intention in entering into the forward sales contracts is for the purpose of delivery of copper in accordance with its sales requirements. Historically, Entity A has a practice of net settling a portion of similar forward contracts, provided the contracts are in the money. For contracts that are out of the money, historically Entity A has opted to physically deliver.

Forward contracts will be accounted for as derivatives.

Definition of Derivative

IFRS

Written option

Case study:

Entity XYZ owns an office building. Entity XYZ enters into a put option with an investor that permits Entity XYZ to put the building to the investor for CU150 million. The current value of the building is CU175 million. The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at Entity XYZ's option.

Accounting by XYZ: Contract though is a derivative scoped out of IAS 39 if the entity's intention is settle the contract by delivering the building if the option is exercised and no past practice of net settling such contracts.

Accounting by investor: Contract will be accounted for as derivative.

Definition of Derivative… Contd

IFRS

Expected purchase, sale or usage requirements

Each contract must be evaluated in its entirety.

Case study:

An entity may have a contract for 100 units, yet its expected usage requirement is for 80 units only. The entity intends to net settle the part of the contract it does not need in its normal course of business. Such partial net settlement can be achieved in different ways, for example, by entering into an offsetting contract for 20 units, or by taking delivery of all 100 units and selling 20 straight away.

The entire contract falls within the scope of IAS 39 since the entire contract cannot be argued to be in accordance with the entity's expected usage requirements.

Definition of Derivative… Contd

IFRS

Expected purchase, sale or usage requirements

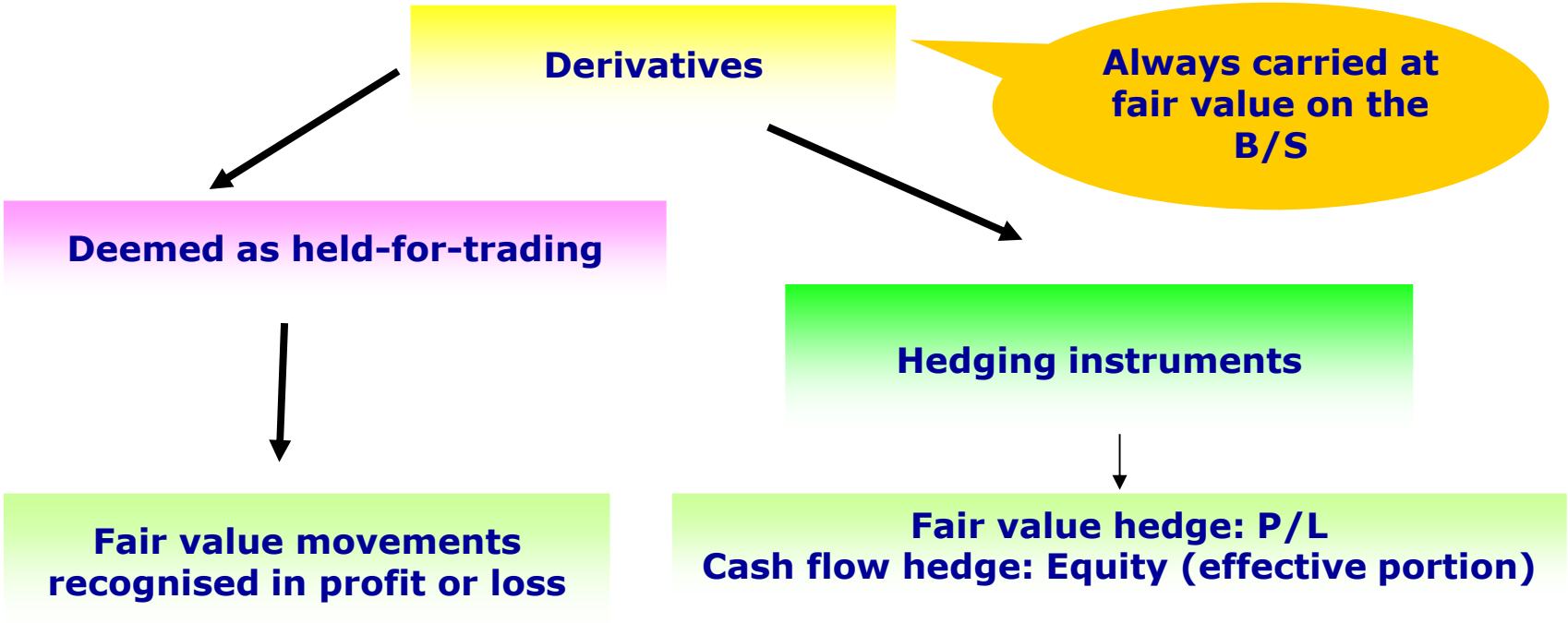
Case study:

Entity X enters into a fixed-price forward contract to purchase one million tonnes of copper. Copper is traded on the London Metals Exchange and is readily convertible to cash. The contract permits X to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Entity X does not have a practice of settling similar contracts net or taking physical delivery of copper and selling it within a short period after delivery for the purposes of generating a profit from short-term fluctuations in price.

Entity to demonstrate that the contract is entered into and continues to be held for the purpose of receipt of copper in accordance with its expected purchase or usage requirements to qualify for scope exemption under IAS 39.

Classification of Derivatives

IFRS



Four Cornerstones of accounting for derivative instrument

IFRS

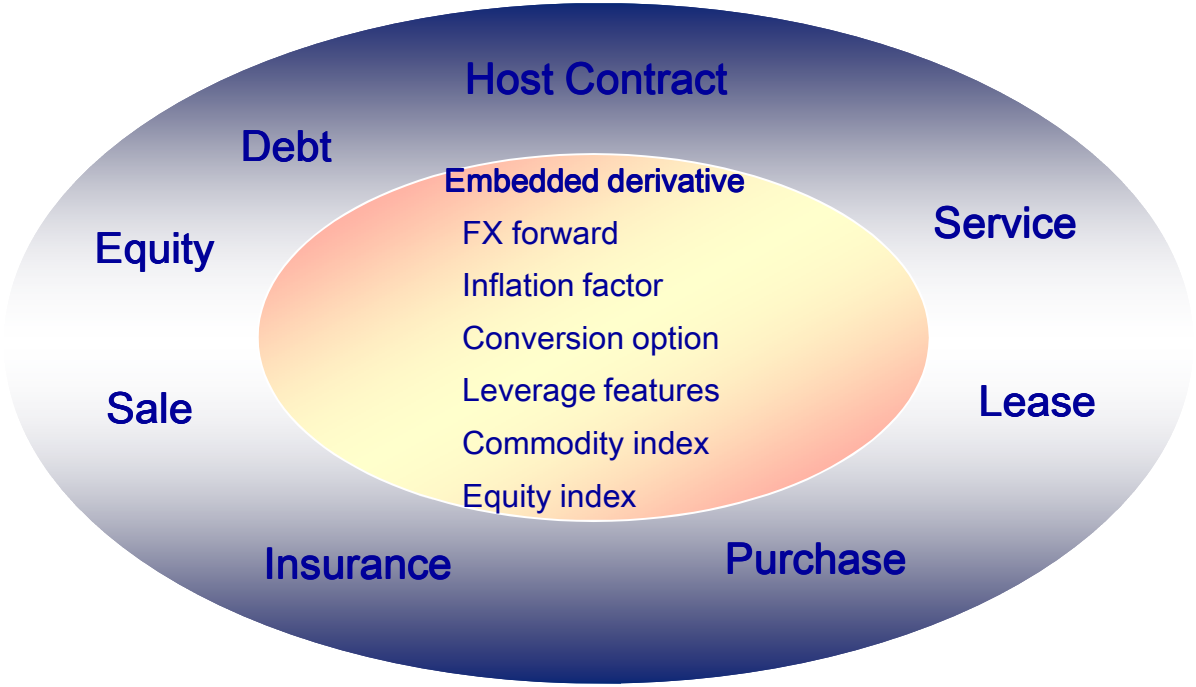
1 Derivative instruments are financial assets or financial liabilities	2 The only relevant measure is fair value.
3 Deemed as held for trading and therefore fair value movements are recognized in P&L A/c.	4 Hedge accounting should be provided only for qualified transactions.

Definition: Embedded Derivatives

IFRS

A component of a hybrid instrument that combines the derivative and a non-derivative host contract – with the effect that some or all of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative

Hybrid Contract



Practical Issues

Identifying the embedded derivatives?

Should the embedded derivatives be accounted for separately from the host contract?

IFRS

Examples of Embedded Derivatives

IFRS

Contracts that are denominated in currencies other than the functional currency of the contracting entities for example Entity T, a UK entity whose functional currency is Sterling, enters into a contract to sell a non-financial item in US dollars. The hybrid contract is the entire sale contract which will be settled in US dollars; the host contract is the Sterling sale contract; the embedded derivative is the foreign exchange Sterling/US dollar forward.

Lease with an inflation factor, such that each year rentals or adjusted for changes in retail price index ;

Contracts that are indexed to certain indices/variables such as an inflation-related index, equity index, foreign exchange movements;

Many Many More

Embedded Derivatives

IFRS

An embedded derivative should be separated from the host and accounted for separately when, and only when:

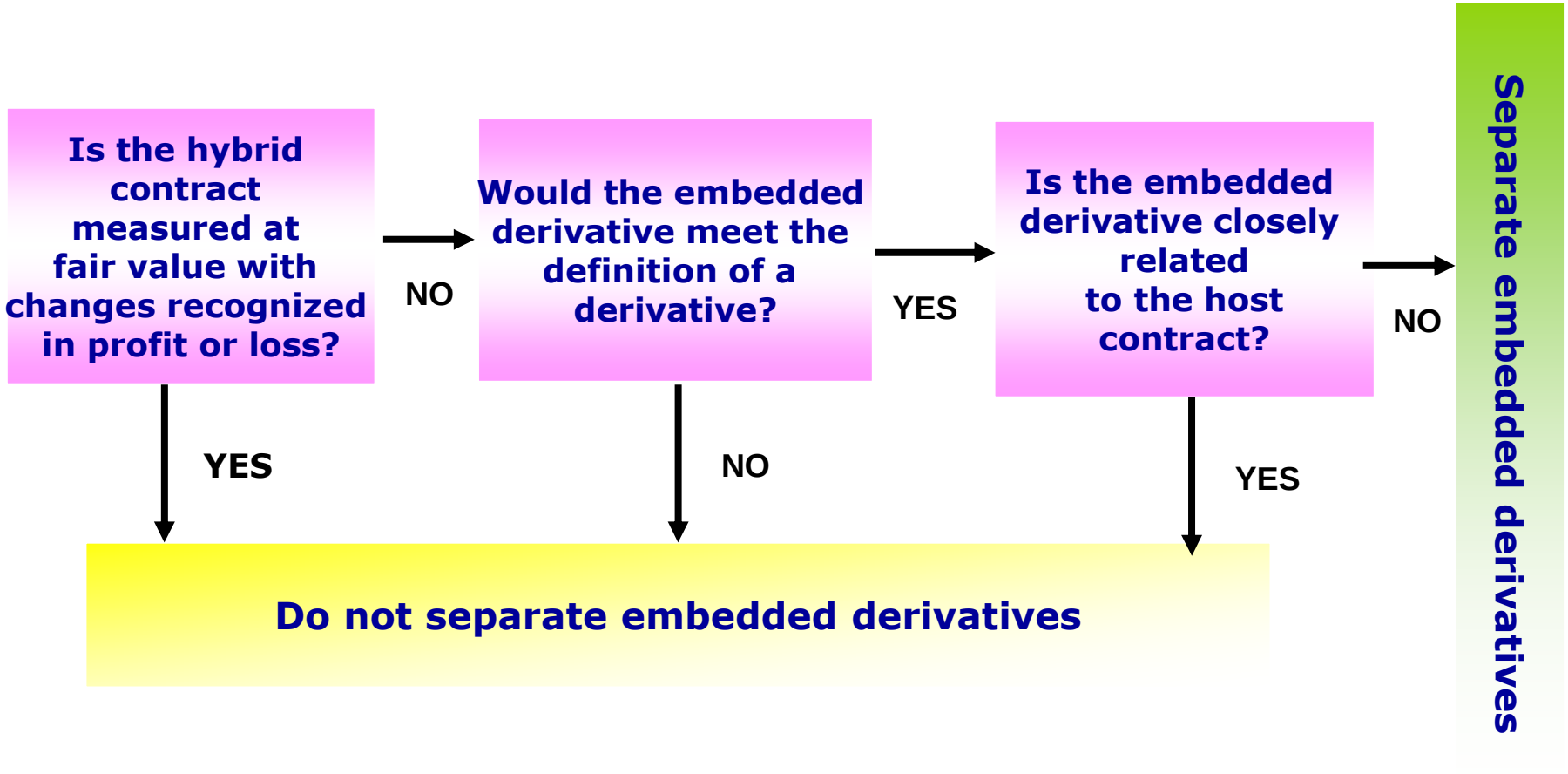
- The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract; (guidance does not specifically refer to a purely quantitative assessment, nor does it refer to a purely qualitative assessment of the Relationship)

- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; AND

- The hybrid instrument is not measured at fair value with changes in fair value recognized in profit or loss.

Embedded Derivatives

IFRS



Embedded derivatives:

IFRS

What are the consequences of separation?

If separated:	If not required to separate:
Host Contract: Applicable IFRS	Apply applicable IFRS to the entire contract
Derivative : At fair value through P&L	If required to separate but unable to measure the derivative, fair value the combined contract

Reassessment of Embedded Derivative

IFRS

Generally prohibited from reassessing the conclusion

Required to revisit the conclusion unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract.

Embedded Derivatives- Executory contracts

IFRS

Little guidance on assessing embedded derivatives in purchase, sale and service contracts

Conclusions will need to be reached by analogizing from the guidance and principles applicable to other host contracts

•Nature of embedded derivatives in executory contracts:

- Pricing adjustment features
- Inflation related features
- Caps, floors and collars
- Foreign currency features

Embedded Derivatives- Executory contracts

IFRS

•Embedded derivatives:

- Inflation related features

Not leveraged and inflation index relates to inflation in the entity's own economic environment – No separation

Leveraged means inflation adjustment for two times or more of the inflation index (by analogy).

Case study

A Indian Entity contracts to purchase a fixed quantity of certain raw materials from an Indian supplier in 12 months' time. The raw materials are intended for use in the entity's business. The purchase price will be market price at the contract date plus as an adjustment for India Retail Price Index from the beginning of the contract. The contract does not contain any leverage feature.

Host contract: Purchase contract
Embedded derivative: Inflation feature
Is embedded derivative closely related to the host: Yes

Embedded derivatives – Executory contracts

IFRS

Price Adjustments factors

Payments determined by changes in a referenced underlying that is not generally connected with the normal pricing of such a contract for example adjustments by reference to interest rates, security prices, unrelated commodity prices contain embedded derivative requiring separation.

Example:

An entity enters into a coal purchase contract that includes a clause that links the price of coal to a pricing formula based on the prevailing electricity price at the date of delivery. The entity purchases coal for own use and no provisions to settle the contract net.

Host contract: Purchase contract

Embedded derivative: Price adjustment factor

Is embedded derivative closely related to the host: No

Embedded derivatives – Executory contracts

IFRS

Caps, floors and collars

Price is set as a market price at the time of the payment, but is ‘capped’, ‘floored’, or ‘collared’.

Cap or floor is not leveraged and out-of-the money at the time of entering into the contract – No separation

Collar- not leveraged and both cap and floor are out –of- the money at the time of entering into the contract – No separation

Assessment at the time of inception and no subsequent revisit.

Embedded derivatives – Executory contracts

IFRS

Case study

A manufacturer enters into a long term contract to purchase a specified quantity of certain raw materials from a supplier. Under the contract, the supplier will provide the materials at the list price at the delivery date, but within a specified range. For example, the purchase price may not exceed C20 per kg or fall below C15 per kg. The current list price at the inception of the contract is C18 per kg.

From manufacturer's perspective:

Host contract: Purchase contract

Embedded derivatives: Purchased call option with strike price of C20 per kg and written put option with a strike price of C 15 per kg.

Are embedded derivative closely related to the host: Yes

Embedded derivatives – Executory contracts

IFRS

Foreign currency features

No separation provided-

- Not leveraged
- Does not contain an option features; and
- Requires payment in one of the currencies a) functional currency of any substantial party to the contract or b) currency in which the price is routinely denominated in commercial transactions around the world or c) currency that is commonly used to purchase or sell non-financial items in the economic environment in which the transaction takes place.

Substantial party - Party acting as principal to the contract , buyer / seller.

Payments denominated in the functional currency of a party to the contract, but the functional currency subsequently changes

Embedded derivatives – Executory contracts

IFRS

Case study

Indian Entity (with INR as functional currency) contracts to sell goods to a French purchaser whose functional currency is the Euro. The contract will be fulfilled by the physical delivery of goods and payments by the French buyer would be made in Euro.

Host contract: Sale contract denominated in INR
Embedded derivative: Foreign currency swap / forward contract to sell INR and buy Euro.

Are embedded derivative closely related to the host : Yes

Embedded derivatives – Executory contracts

IFRS

Foreign currency features (contd.)

Entity A, a car dealership, contracts to purchase cars from Entity B, a car manufacturer. Companies A and B have functional currencies of Indian Rupees and Euro respectively. The purchase agreement allows A to choose whether to settle the contract in a fixed amount of either Indian Rupees or Euros.

Host contract: Purchase contract

Embedded derivative: Foreign currency option

Are embedded derivative closely related to the host: No

Entity X, an Indian entity, enters into a sales contract with Entity Z, a US entity. Payments are in US dollars, but embedded in the contract is a clause such that payments are adjusted for twice the change in the US dollar exchange rate for the period that the payment is outstanding.

Host contract: Sales contract

Embedded derivative: Foreign currency derivative

Are embedded derivative closely related to the host: No

Embedded derivatives – Executory contracts

IFRS

Entity A, whose functional currency is Indian Rupees, enters into a contract with Entity B whose functional currency is Euro, to purchase oil in six months for USD 10Million. The oil contract includes a leveraged foreign exchange provision that states that parties , in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in exchange rate of the USD and INR applied to a notional amount.

Host contract: Purchase contract

Embedded derivative: Leveraged foreign exchange provision

Is embedded derivative closely related to the host: No

Embedded derivatives – Executory contracts

IFRS

Entity A, a India based entity with INR as its functional currency, enters into a contract to purchase iron ore from a supplier, Entity B, in six months for a fixed amount of HKD. HKD is not the functional currency of either party to the transaction. The iron ore will be delivered and used over a reasonable period in the normal course of business.

Host contract: Purchase contract

Embedded derivative: Foreign currency forward to sell HKD and buy INR

Is embedded derivative closely related to the host: No

Off- balance sheet executory contract to sell INR and buy iron ore. Embedded derivative is a non optional derivative with a fair value of zero at inception.

Embedded Derivatives – Lease host contracts

IFRS

Finance lease contracts are financial instruments and accounted under AS – 19 – Leases. However, any derivatives embedded in lease contracts are with in the scope of IAS 39.

Embedded derivatives can exist in lease contracts , whether an entity is acting as a lessee or lessor in either a finance lease or an operating lease.

Nature of embedded derivatives in lease host contract:

- Inflation indexed rentals
- Contingent rentals
- Purchase options
- Term extension or renewal options
- Lease payments in foreign currencies
- Residual value guarantee

Embedded Derivatives – Lease host contracts

IFRS

Inflation indexed rentals

Closely related provided:

The index is not leveraged and the index relates to inflation in the entity's own economic environment.

Case study:

An Indian entity leases a property in France. The rentals are paid in Euros and increases each year in line with the increase in the rate of inflation in France. The lessor located in France.

Index is not leveraged and index relates to the economic environment in which the property is located. Hence inflation indexed rental need not be separated.

Embedded Derivatives – Lease host contracts

IFRS

Contingent rentals based

- on related sales – No separation
- A variable interest rate – No separation
- On other balances such as profit – Generally separation required
- Other referenced underlying such as commodity price - separation required.

Case study:
An Indian Entity leases a property in India. The lease rentals are indexed to MIBOR. The contract is not leveraged.

Host contract: Lease contract
Embedded derivative: Rentals based on MIBOR
Is separation required: No

Embedded Derivatives – Lease host contracts

IFRS

Purchase options in lease agreements – Not an embedded derivative. If the terms of the contract allows the lessee to settle net in cash or the leased asset is readily convertible into cash, the purchase option could qualify as a derivative.

Term extensions or renewal options – Not an embedded derivative

Residual value guarantee in lease agreements - Not an embedded derivative and accounted under AS 17

Lease payments in foreign currency features – Evaluation of conditions for foreign currency embedded features required

Case study

A UK Company enters into an operating lease with a European lessor that is denominated in Euros. The functional currency of the lessee and lessor are the pound sterling and the Euro respectively.

Host contract: Lease contract

Embedded derivative: Foreign currency forward

Is separation required?: No

Embedded Derivatives – Equity host contracts

IFRS

Call option (enables the issuer to re-acquire that equity instrument at a specified price) - Not closely related to the host equity instrument from holders perspective. From issuer's perspective, the call option is an equity instrument under IAS 32, in which case it is excluded from the scope of IAS 39.

Put option (that requires the issuer to an equity instrument to acquire at a specified price) - Not closely related to the host equity instrument from holders perspective. From the issuer's perspective , recognize a financial liability equal to the present value of the redemption amount.

Case study

An entity issues Rs 50 million of irredeemable preference shares that gives the holders a preferential right to return of capital in a winding up, but which are also convertible into a fixed number of ordinary shares at the holder's option. Any dividends paid in the year are at the discretion of the issuer.

Host contract: Equity

Embedded derivative: Conversion feature

Is the embedded derivative required to be separated: No

Embedded Derivatives – Debt host contracts

IFRS

Nature of embedded derivatives in debt host contracts:

Puts, calls and prepayment options

Term extending features

Indexed interest and principal payments

Inflation features

Foreign currency features

Caps, floors and collars on interest rates

Conversion and equity features

Embedded Derivatives – Debt host contracts

IFRS

Puts, calls and prepayment options

Not closely related unless the option's exercise price is approximately equal to the debt's amortized cost on each exercise date.

An entity issues the following debt instruments:

5 year Zero coupon debt for proceeds of Rs 7 million with a face value of Rs 10 million. The debt is callable by the issuer at its amortized cost calculated on the basis of effective interest rate method in the event of a change in control.

5 year Zero coupon debt for proceeds of Rs 7 million with a face value of Rs 10 million. The debt is puttable at its face value in the event the issuer has an IPO.

Embedded Derivatives – Debt host contracts

IFRS

Term extending features – Not closely related unless there is a concurrent adjustment to the approximate current market rate of interest at the time of extension.

Case study

An entity issues 6% fixed rate debt that has fixed term of 3 years. The entity is able to extend the debt before its maturity for an additional two year period at the same 6% interest.

Term extending option is an embedded derivative requiring separation.

Embedded Derivatives – Debt host contracts

IFRS

Indexed interest and principal payments

Equity indexed and commodity indexed are not closely related.

Indexed to the underlyings that are typically associated with debt – not closely related **either the holder would not recover** substantially all of its recognized investment **or the issuer would pay more** than twice the market rate of the host contract at inception (of issuing the instrument) **and could result in a rate of return that is at least twice what** the market return would be for a similar host contract.

Case study

Entity X issues 10-year notes with no stated coupon. Embedded in the notes is a provision that adjusts the interest paid by reference to changes in the price of gold.

Entity X issues Rs.10 million in debt with an 8 per cent coupon. However, if MIBOR increases by 500 basis points within any one year, the bonds mature and the holder receives Rs. 8 million in total.

Embedded Derivatives – Debt host contracts

IFRS

Inflation features

Closely related provided: the inflation index is not leveraged, can not cause the investor not to recover substantially all of its initial investment and the index relates to inflation in the economic environment for the currency in which debt is denominated.

Case study

Entity X purchases an inflation-linked bond. The bond pays a coupon of 4 per cent annually, with a repayment of principal on maturity of the bond. The principal payment is indexed to the domestic retail price index but cannot decrease below par.

Embedded Derivatives – Debt host contracts

IFRS

Foreign currency features

Foreign currency derivative considered closely related since foreign currency loan is accounted for under IAS 21. This applies to embedded foreign currency derivative.

An entity with INR as a functional currency issues Rs. 10 million debt instrument that provided for annual interest payments in Euros and the principal repayment in INR.

Embedded derivative: Currency swap (INR interest into euro interest)

Is closely related: Yes

Embedded foreign currency derivative with foreign currency option needs to be separated.

An entity issues a Rs 40 million loan at an above average market rate. The entity has the option to repay the loan at par for Rs 40 million or a fixed amount of in a foreign currency , say USD 1 million**.**

Embedded derivatives – Debt host contract

IFRS

Caps, floors and collars

Interest rate is ‘capped’, ‘floored’, or ‘collared’.

cap or floor is not leveraged and out-of-the money at the time of entering into the contract – No separation

Collar- not leveraged and both cap and floor are out –of- the money at the time of entering into the contract – No separation

Case study

Entity X issues CU100 million debt with a five-year maturity. The interest is payable at LIBOR plus a credit spread of 150 basis points. LIBOR at issuance is 4.5 %, and therefore the rate at inception of the debt is 6 %. There is a provision in the debt contract that if LIBOR were to rise, the rate payable on the debt would not rise above 7 per cent.

cap is out-of-the money at the time of issuance. Hence closely related.

Embedded derivatives – Debt host contract

IFRS

Conversion option

Conversion option is an embedded derivative that is not closely related to the host contract (both from issuer's and holder's perspective. But accounting differs).

Split accounting (from issuer's end)– Compound Instruments that contain both liability and equity in a single contract. – Residual value method

Example – Convertible debt with put and call option

In case compound instrument contains non equity derivative features such as call, put , it is necessary to assess whether these are closely related to the host debt contract. It is assessed before splitting the equity component. (This separation should not affect the amount determined for the equity component but it affects the value of liability component).

Contract settled in the equity's own shares	Monetary value of consideration*	Number of Equity shares	Classification
Scenario 1	Fixed	Variable	Financial liability
Scenario 2	Variable	Variable	Financial liability
Scenario 3	Variable	Fixed	Financial liability
Scenario 4	Fixed in a currency other than the entity's functional currency	Fixed	Financial liability
Scenario 5	Fixed	Fixed	Equity

* In the functional currency of the issuer.

IFRS

Accounting for Embedded Derivatives

IFRS

Measure at fair value, with changes in fair value accounted for through profit or loss ('FVTPL').

Host contract's carrying value = Consideration paid or received to acquire the hybrid contract – fair value of the embedded derivative

Quoted price is the best evidence of fair value. In the absence of such price, valuation techniques are used.

If the embedded derivative's fair value is not reliably determinable then fair value of the embedded derivative = Fair value of the hybrid contract – Host contract's fair value. If the entity is unable to determine the fair value of embedded derivative using this method either at inception or at a subsequent reporting date, fair value the hybrid contract and designate as at FVTPL.

Multiple embedded derivatives

Multiple embedded derivative – Treat as a single compound embedded derivative unless derivatives relate to different risk exposures and are readily separable and independent of each other.

Post separation of the embedded derivative, host contract should be accounted for in accordance with IAS 39 if it is a financial instrument else, in accordance with other appropriate standards.

Accounting for Embedded Derivatives

IFRS

Case study:

An entity issues callable 20,000 convertible bonds at a total par value of INR 20 million. Each bond pays fixed interest and is convertible at any time up to maturity into the entity's ordinary shares. Each bond also contains an embedded call option that gives the bond's issuer the right to call and redeem the bond at anytime before maturity.

The bond has two embedded options that are held by different parties. The bond's holder has the option to convert the bond into a specified number of shares. The issuer has the option to call back the bond and pay an amount generally at a premium over par value.

Issuer's perspective: Call option needs to be accounted separately unless the option exercise price is approximately equal to the amortized cost of the host debt instrument. Also conversion option needs to be evaluated separately.

Measurement

IFRS

Notwithstanding the compliance with the conditions to separation of embedded derivative , an entity may designate the entire hybrid contract as a financial asset or financial liability at Fair Value Through Profit or Loss unless:

Embedded derivative (s) dose not significantly modify the cash flows that otherwise would be required by the contract **or**

it is clear with little or no analysis when a similar hybrid instrument is first considered that separation is prohibited.

Section III – Guarantees and De-recognition

Financial Guarantee contracts

IFRS

Contracts that require 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.

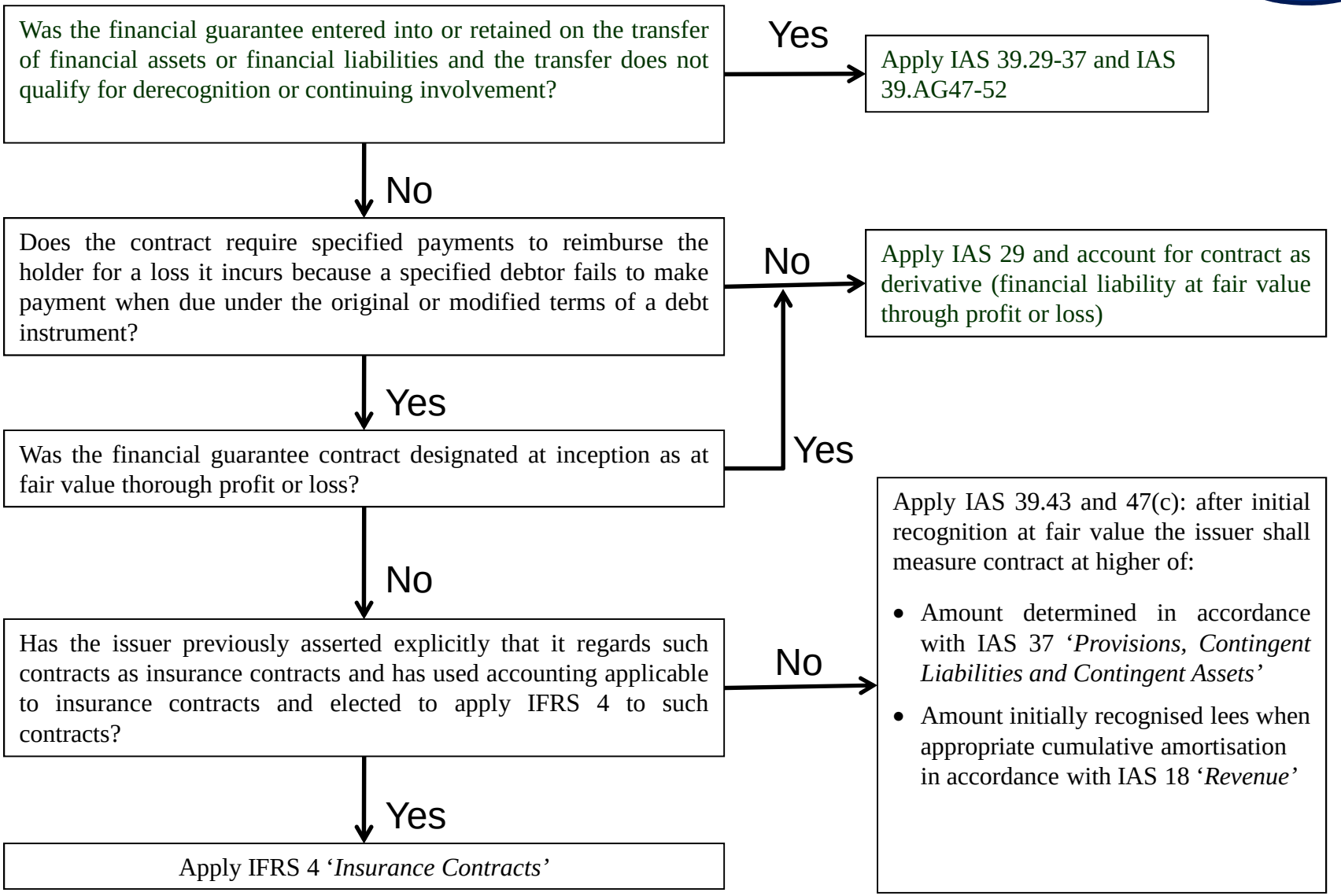
Case study

Entity A owns CU100 million of Entity X bonds that mature in twenty years. Entity X is rated BBB by the rating agencies. Entity A is concerned that Entity X may be downgraded and the value of bonds would decline. To protect against such a decline, Entity A enters into a contract with a bank that will pay Entity A for any decline in the fair value of the Entity X bonds related to a credit downgrade to BB or below. The contract is for a five-year period, and Entity A pays CU2 million to enter into the contract.

As the contract pays Entity A in the event of a downgrade, and not in the event of a failure by Entity X to meet its payment obligations under the issued bonds, it is a derivative instrument within the scope of IAS 39 from the point of view of both Entity A and the bank who is the counterparty to the contract.

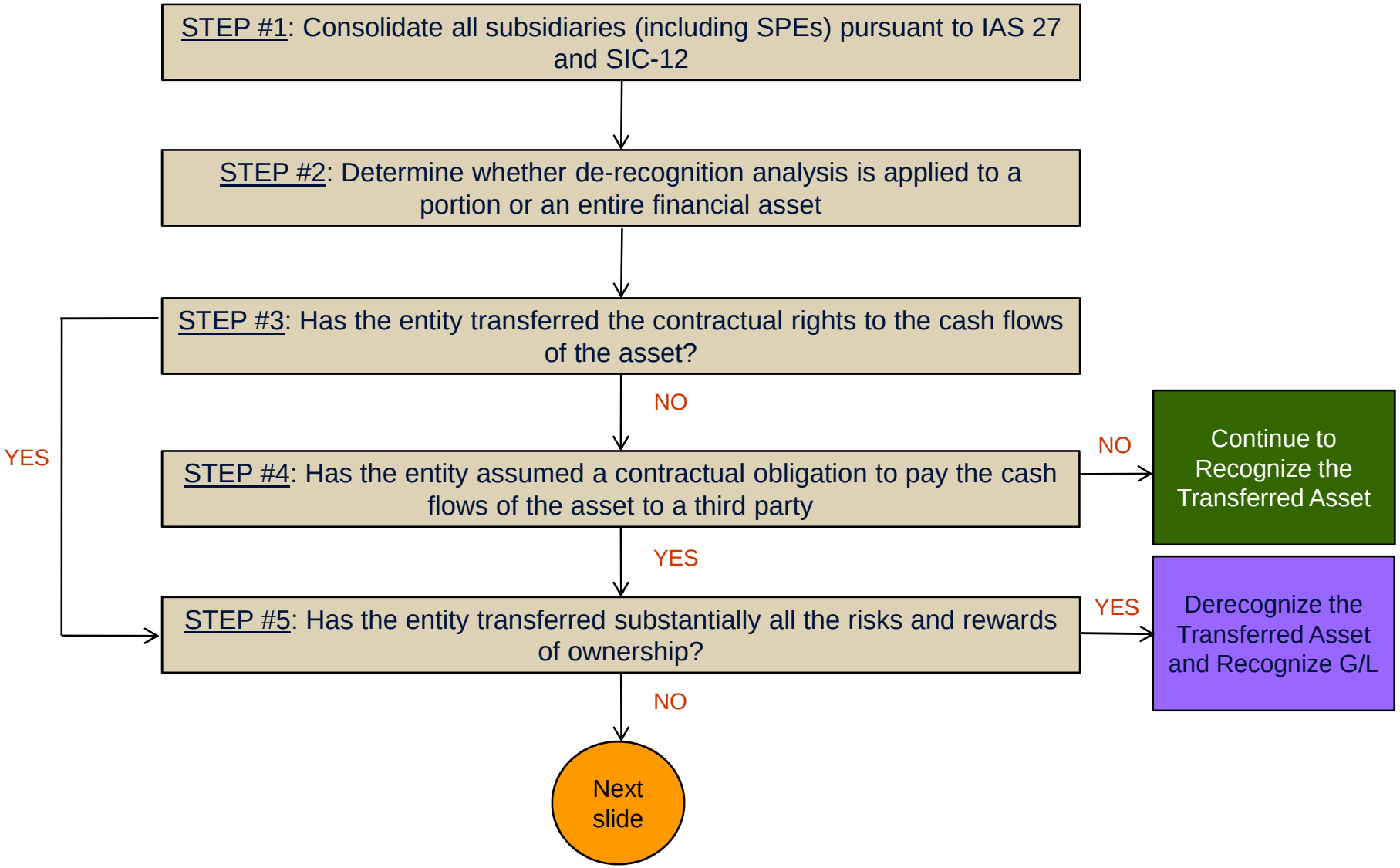
The following decision tree summarises the treatment of issued financial guarantees

IFRS

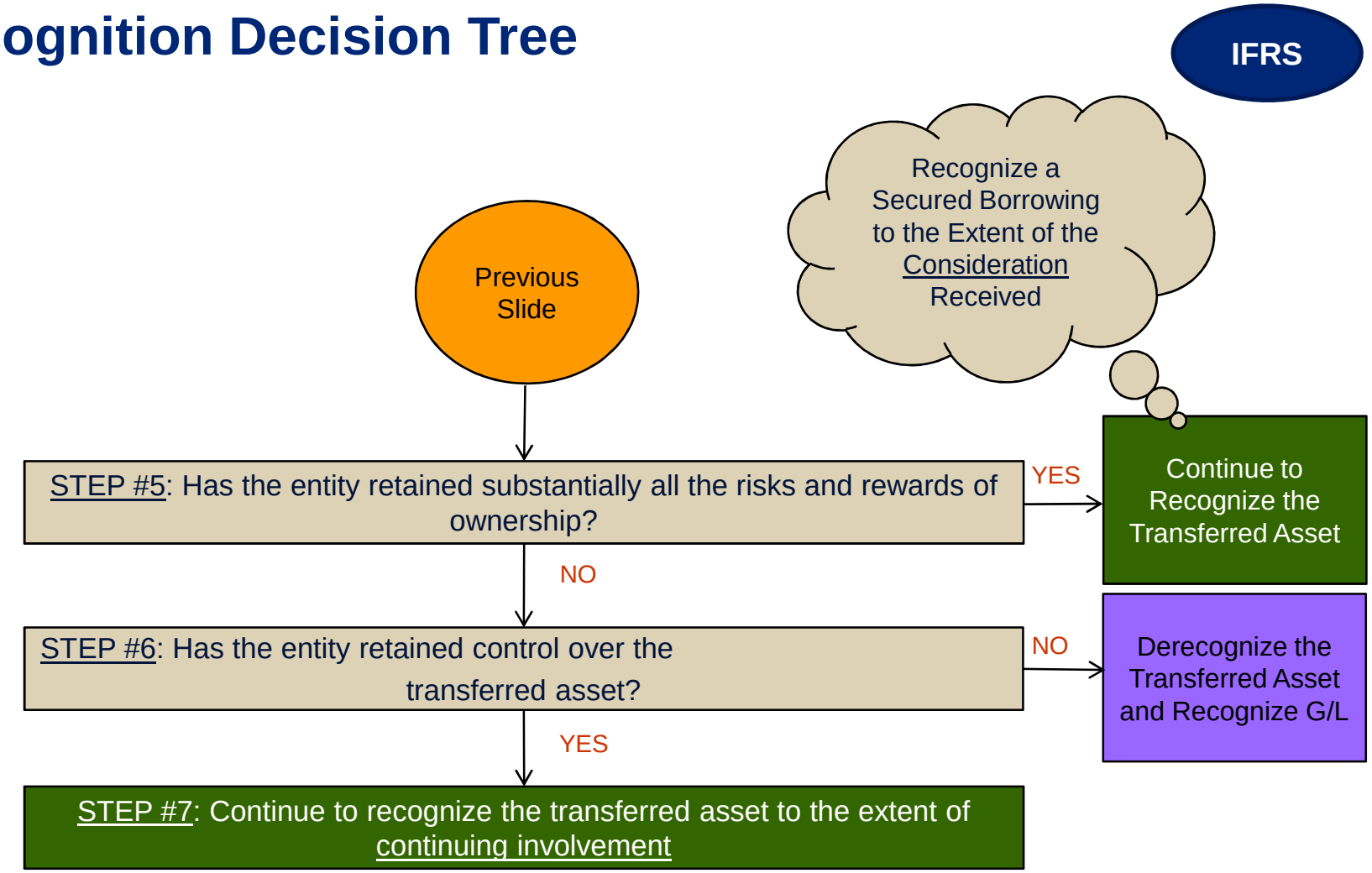


Derecognition of financial assets

IFRS



Derecognition Decision Tree

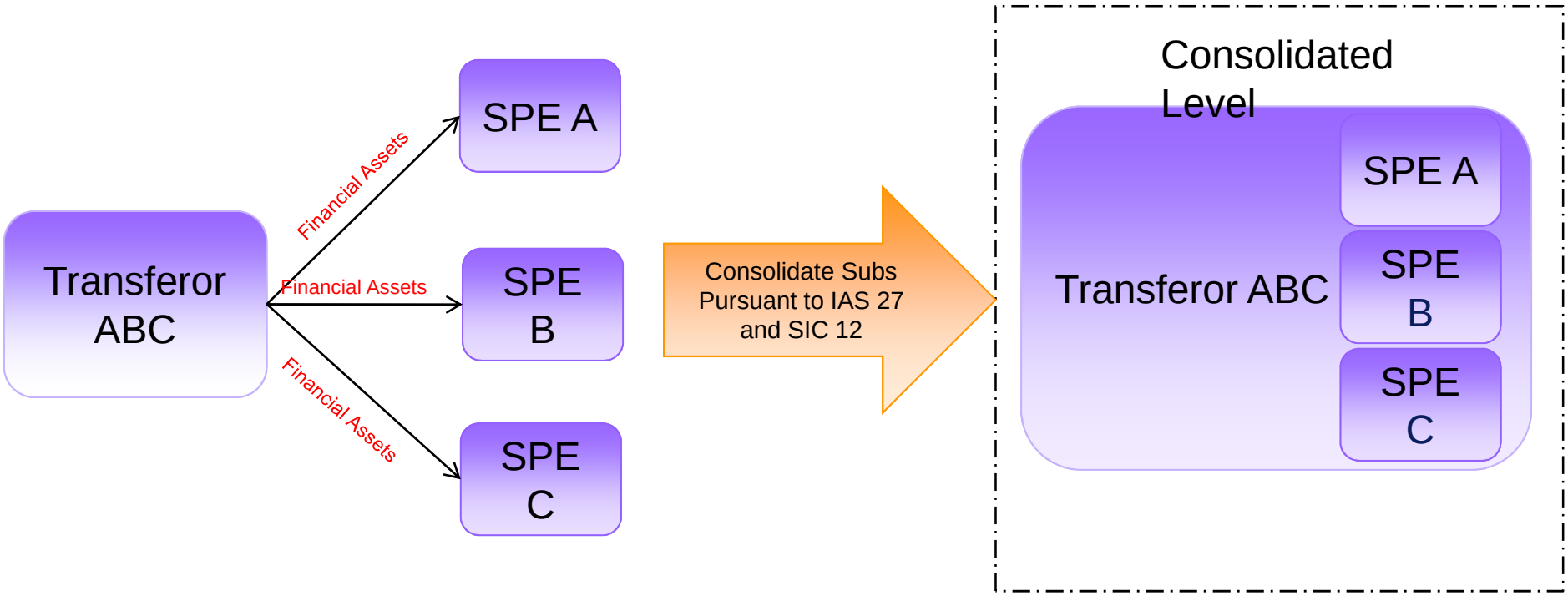


Derecognition Decision Tree: Step #1

IFRS

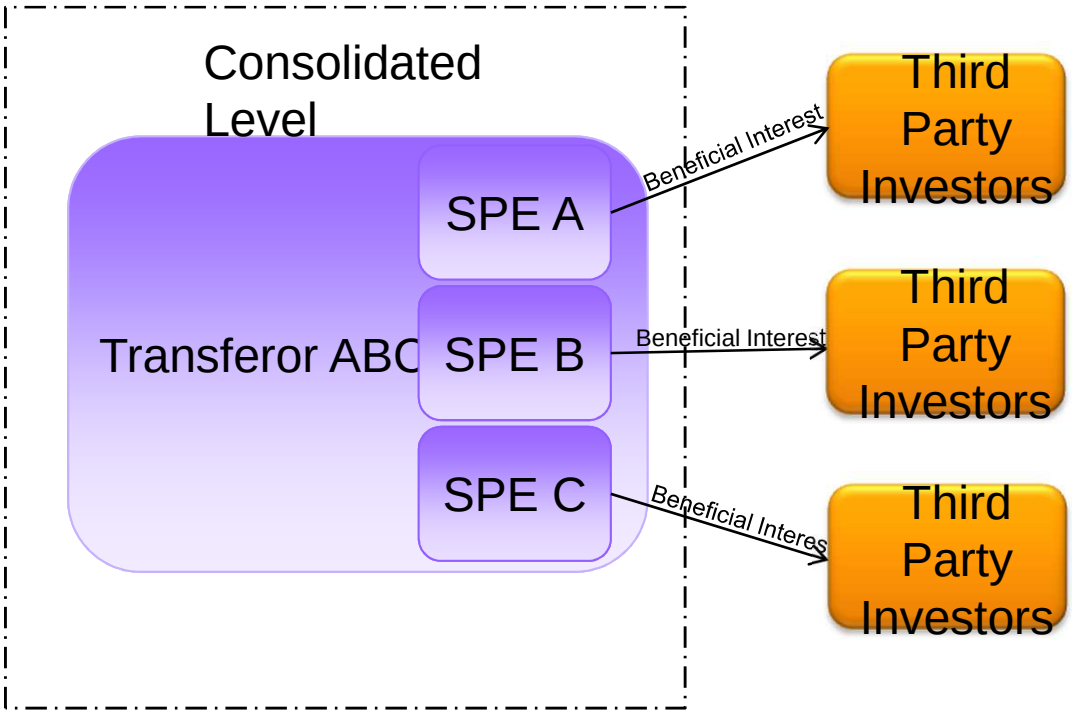
Step #1: Consolidate all subsidiaries
(including any applicable SPEs)

Derecognition considered at the consolidated group level



Derecognition Decision Tree: Step #1

IFRS



There are two circumstances where derecognition may be achieved:

- SPEs transfer contractual rights to the cash flows of the transferred asset to a third party (see Steps #5 and #6); or
- SPEs assume a contractual obligation to pass through the cash flows of the transferred asset to the third-party investors (see Step #4).

Derecognition Decision Tree: Step #2

IFRS

Step #2: Determine whether the de-recognition analysis is applied to a portion or an entire asset

De-recognition is applied to a part of an asset transferred if the part comprises only:

- Specifically identified cash flows (i.e., an I/O strip);
- A fully proportionate (pro rata) share of cash flows (i.e., 90 percent of the cash flows); or
- A fully proportionate share of specifically identified cash flows (i.e., 90 percent of the I/O strip).

In all other cases, apply derecognition analysis to the entire transferred asset.

Derecognition Decision Tree: Step #3 Example

IFRS

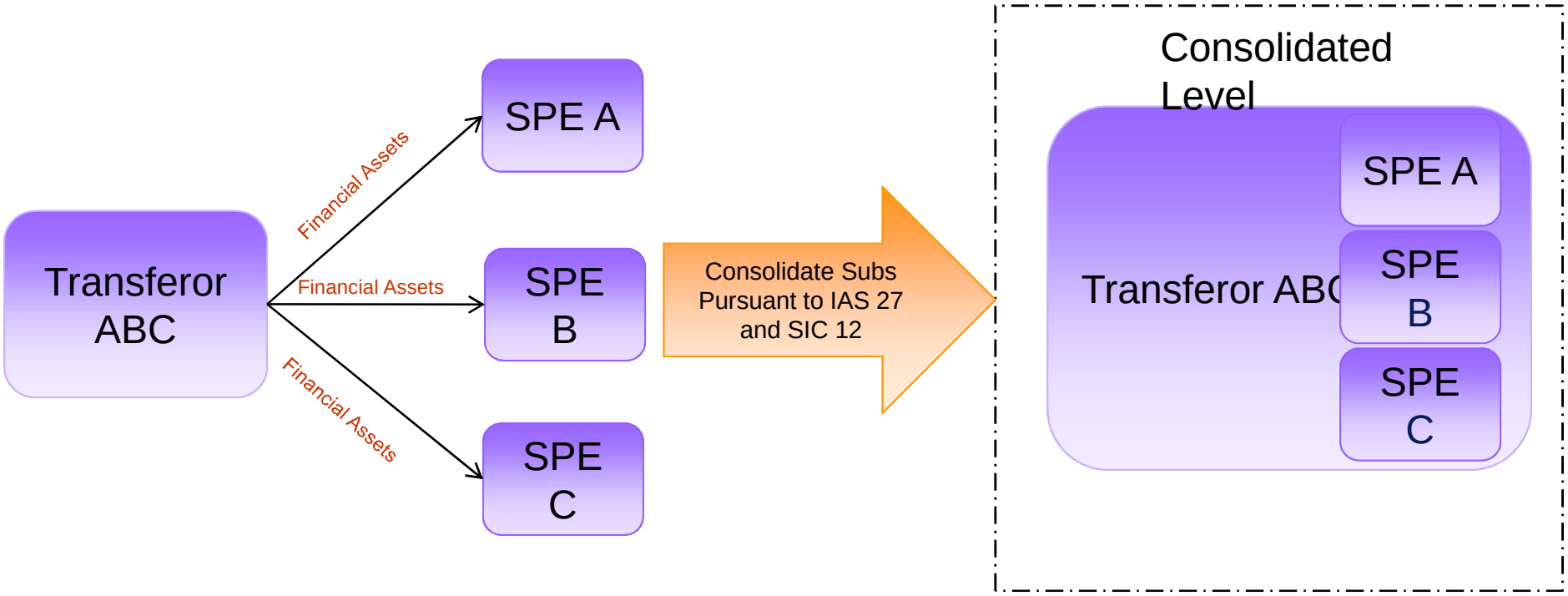
Example: Transferor ABC transfers financial assets to an SPE that its establishes for the purpose of securitizing the financial asset. Pursuant to SIC-12, the SPE is consolidated by Transferor ABC and presented as part of its consolidated financial statements.

Question: When determining whether to derecognize the transferred asset, has Transferor ABC transferred the rights to the contractual cash flows of the transferred asset to a third party?

Derecognition Decision Tree: Step #3 Example

IFRS

Do not Forget Step 1 in Decision Tree



Derecognition Decision Tree: Step #3 Example

IFRS

Answer: No — The Contractual Rights are Retained.

Because Transferor ABC includes the SPE in its consolidated financial statements and the contractual rights to the cash flows of the transferred assets are held by the SPE, Transferor ABC must consider whether it assumes an obligation to pass through the cash flows of the transferred asset in order to achieve derecognition. See Step #4.

Derecognition Decision Tree: Step #4

IFRS

Step #4: Has the entity assumed an obligation to pass the cash flows of an asset to one or more entities?

To achieve derecognition, Transferor ABC must enter into a "pass-through arrangement" that meets the following:

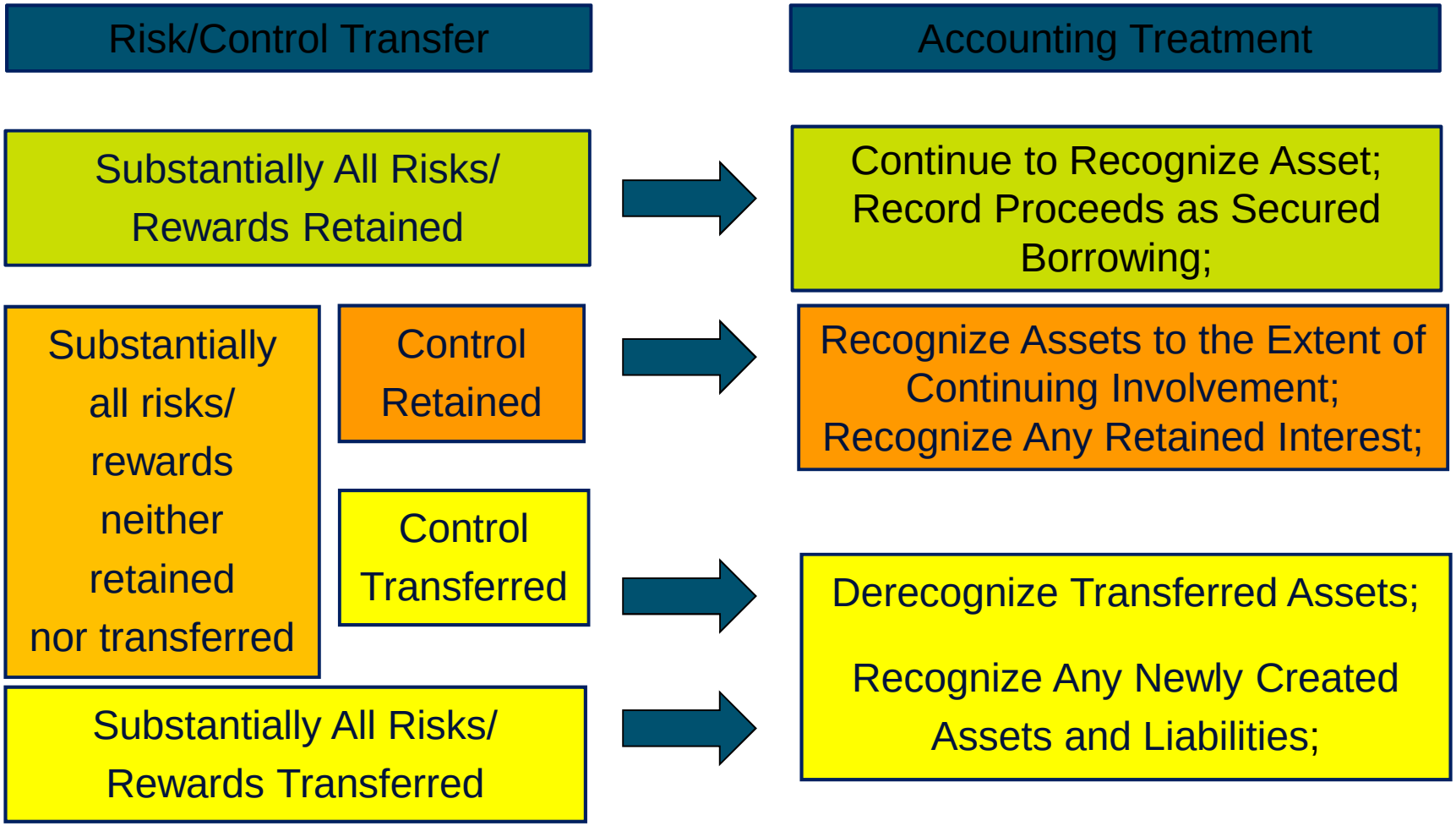
- Transferor ABC has no obligation to pay amounts **not collected.**
- Transferor ABC has an obligation to remit **all amounts collected** without material delay.
- Transferor ABC is prohibited from selling or pledging the transferred asset.

Even if the obligation meets the definition of a "pass-through arrangement," Transferor ABC still must consider whether substantially all the risks and rewards of ownership are transferred (see step #5).

Derecognition Decision Tree: Step #5

IFRS

Step #5: Has the entity transferred the risks and rewards of ownership?



Consideration: “Risks and Rewards Transferred”

IFRS

Consider the entity’s exposures before and after transfer:

- Focus on variability in the amounts and timing of net cash flows of the transferred asset.
- Calculation of variability is similar to CON 7, Using Cash Flow Information and Present Value in Accounting Measurements.
- Risks and rewards are retained if exposure to variability in cash flows do not change significantly as a result of the transfer.

Consideration: “Risks and Rewards Retained”

IFRS

Examples of when substantially all risk and rewards **are retained** (paragraph AG40 of IAS 39):

- A sale of a financial asset and repurchase transaction with a fixed settlement price
- A securities lending arrangement
- A sale of a financial asset with a total return swap that transfers market exposure back to seller
- A sale of a financial asset with a deep in the money call option
- A sale of a financial asset with a credit guarantee provided to the transferee

Examples of when substantially all risk and rewards **are transferred** (paragraph AG39 of IAS 39):

- An unconditional sale of a financial asset
- A sale with a first right of refusal clause
- A sale with an option to repurchase at fair value
- A sale with a fixed price call that is deeply **out of the money**

Derecognition Decision Tree: Step #5

IFRS

If substantially all risks and rewards are **transferred**:

- Derecognize the transferred asset
- Recognize separately as assets and liabilities any rights and obligations created or retained (i.e., servicing rights, guarantees, and retained beneficial interests)
- *New* assets or liabilities received are initially measured at fair value
- Retained interest is initially measured based on allocation of previous carrying amounts

If substantially all risks and rewards are **retained**:

- Continue to recognize the transferred asset
- Recognize a secured borrowing to the extent of consideration received
- The asset and associated liabilities shall not be offset
- Interest income and interest expense shall not be netted in the P&L

Derecognition Decision Tree: Step #6

IFRS

Step #6: Determine whether control over the transferred asset is retained

Control under IAS 39 focuses on whether the transferee:

- Has the practical ability to sell asset to third party
- Is able to exercise that ability unilaterally; and
- Does not need to impose additional restrictions on the transfer

Control under IAS 39 does not consider legal isolation

Consideration: “Control”

IFRS

Considerations when assessing control:

- Is the asset readily obtainable in the market?
- Does the transferor have a call option?
- Does the transferee have a sufficiently valuable put option so as to constrain the transferee from selling the asset without attached strings?
- What can the transferee do in practice?

Examples: “Control”

IFRS

Examples of when control is retained (paragraph AG51 of IAS 39):

- Purchased call option on not readily obtainable assets
- Cleanup call
- Written put option on not readily obtainable assets
- Guarantee or subordinate interest

Remember: If control is retained, the transferred asset (and the associated liability) continues to be recognized only to the extent of the transferor’s continuing involvement.

Consideration: “Continuing Involvement”

IFRS

Continuing involvement: The extent to which a transferor continues to be exposed to changes in value of the transferred asset

Examples include:

- A guarantee — The transferred asset continues to be recognized at the lower of (1) the amount of the asset and (2) the maximum amount of consideration that the transferor could be required to pay back.
- A purchase call — The transferred asset continues to be recognized at the amount of the transferred asset that the transferor could repurchase.
- A written put on asset measured at fair value — The transferred asset continues to be recognized at the lower of the fair value of the asset or the option exercise price.

Mini Cases

IFRS

During the reporting period, Entity A has sold various financial assets. Help Entity A evaluate the extent to which derecognition is appropriate in each of the following cases:

1. Entity A transfers ownership of a financial asset to a third party for $10,000. No rights or obligations associated with the asset are retained by Entity A.

Answer:

Entity A appears to have transferred the contractual rights to the cash flows of the assets. Substantially all risks and rewards of ownership have been transferred; control has not been retained.

Derecognition of the transferred asset appears appropriate.

Mini Cases

IFRS

2. Entity A sells an investment in shares for $10,000, but retains a call option to repurchase the shares at any time at a price equal to their current fair value on the repurchase date.

Answer:

Entity A appears to have transferred the contractual rights to the cash flows of the assets. Substantially all risks and rewards of ownership have been transferred based on the fact that the call option is exercisable at fair value.

Derecognition of the transferred asset appears appropriate.

Mini Cases

IFRS

3. Entity A sells a portfolio of short-term account receivables for $100,000 and promises to pay up to $3,000 to compensate the buyer if and when any defaults occur. Expected credit losses are significantly less than $3,000 and there are no other significant risks.

Answer:

Entity A appears to have transferred the contractual rights to the cash flows of the assets. Substantially all risks and rewards of ownership have been retained based on the fact that credit risk, which is the only significant risk from the transferred assets, is covered by the transferor.

Derecognition of the transferred asset is not appropriate.

Mini Cases

IFRS

4. Entity A sells a portfolio of receivables for $10,000, but retains the contractual right to receive the cash flows and the right to service the receivables for a fixed fee (i.e., to collect payments on the receivables and passing them on to the buyer of the receivables). The servicing arrangement meets the pass-through conditions.

Answer:

Entity A did not transfer the contractual rights to the cash flows of the assets, but has assumed a contractual obligation to pay the cash flows of the assets to a third party. If the entity has transferred substantially all the risks and rewards of ownership or has not retained control over the transferred assets, derecognition is appropriate.

Entity A will recognize a newly created asset for the servicing rights.

Mini Cases

IFRS

5. Entity A sells an investment in shares for $10,000 and simultaneously enters into a total return swap with the buyer under which the buyer will return any increases in value to Entity A and Entity A will pay the buyer interest plus compensation for any decreases in the value of the investment.

Answer:

Entity A has retained substantially all the risks and rewards of ownership based on the fact that the total return swap compensates the transferee for any decrease in the fair value of the investment and the transferor for any increase in the fair value of the investment.

Derecognition is not appropriate.

Mini Cases

IFRS

6. Entity A sells a portfolio of receivables for $100,000 and promises to pay up to $3,000 to compensate the buyer if and when any defaults occur. Expected credit losses significantly exceed $3,000.

Answer:

Entity A appears to have transferred the contractual rights to the cash flows of the assets. Some risks and rewards of ownership have been retained by the transferor based on the fact that credit losses up to $3,000 are covered by Entity A. Other risks and rewards of ownership have been transferred because total credit losses are expected to exceed $3,000. Therefore, the transferor is required to assess whether it has retained control. Assuming Entity A has retained control, it would continue to recognize the transferred asset to the extent of its continuing involvement
(i.e., $3,000).

De-recognition of Financial liabilities

IFRS

De-recognised when , and only when, it is extinguished i.e obligation under the contract is discharged, cancelled or expired.

When entity pays another entity to assume the obligation, the liability is not extinguished until a legal release from the obligation is obtained.

Upon extinguishment recognize the profit / loss in p&l as below: Carrying amount of the liability – (consideration paid+ non-cash assets transferred + new liabilities assumed eg guarantee)

Renegotiation of a financial liability

Exchange instruments with term are substantially different – Account the exchange as extinguishment

De-recognition of Financial liabilities

IFRS

Modification of the term – extinguishment if the modifications are substantial.

If NPV cash flows under the new liability is at least 10% different from the NPV of the remaining cash flows of the existing liability (both discounted at the original effective interest rate of the original liability), the terms are substantially different.

Same basis for modification.

Difference in the carrying amount – if “substantial “ passed, recognized in the P&L immediately, else effective interest rate is modified and consequently, the difference is recognized over a period of time.

Questions?

IFRS

Section IV – Hedge

Types of hedge

IFRS

Three types of hedges depending on the nature of risk exposure:

Fair value hedge

Cash flow hedge

Net investment hedge

Fair value hedge

A fair value hedge is a hedge of the exposure to changes in fair value of a recognized asset or a liability or an unrecognized firm commitment or an identified portion of such an asset, a liability or a firm commitment that is attributable to a particular risk and could affect profit or loss.

Fairvalue hedge

IFRS

Fair value exposures arise from existing assets or liabilities, including firm commitments.

Fixed-rate financial assets and liabilities have a fair value exposure to changes in market rates of interest and changes in credit quality.

Non-financial assets have a fair value exposure to changes in their market price, e.g. a commodity price.

Assets and liabilities are commonly fair value hedged:

1. fixed rate liabilities like loans;
2. fixed rate assets like investments in bonds;
3. investments in equity securities; and
4. firm commitments to buy/sell non-financial items at a fixed price

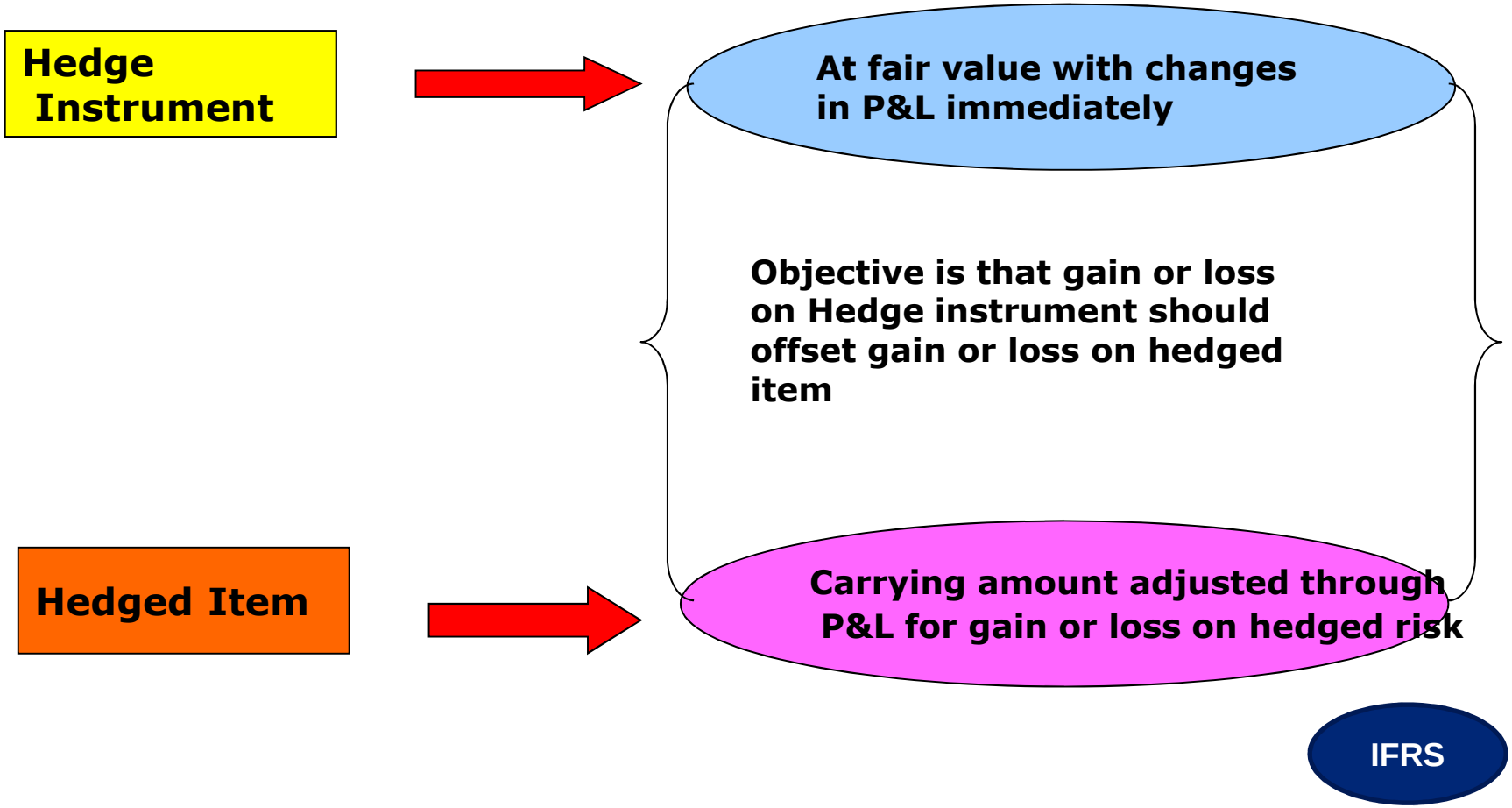
Fair value hedge

IFRS

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or Dates.

Hedges of firm commitments are generally treated as fair value hedges under IAS 39. However, there is one exception: if an entity is hedging the foreign currency risk in a firm commitment this may be accounted for either as a fair value hedge or a cash flow hedge.

Fair Value Hedge-accounting Mechanism



Fair value hedge

IFRS

Discontinue hedge accounting prospectively when:

1. Hedging instrument expires or sold or terminated or exercised

Accounting: Derecognize the instrument and freeze basis adjustments. The entity either continues as part of the carrying amount up to the date the carrying value is recovered through use or sale or the asset becomes impaired or amortized thro' p&l for interest bearing financial instruments (see note below)

2. Hedge no longer meets the hedge accounting criteria

Accounting: MTM the instrument and freeze the basis adjustments.

3. The entity de-designates the hedging relationship

Accounting: Same as 2 above

4. Hedged item is sold or extinguished

Accounting: MTM the instrument and derecognize the hedged item.

Note:

Any adjustment to the carrying amount of the hedged item for the designated risk for interest-bearing financial instruments is amortized to profit or loss, with amortisation commencing no later than when the hedged item ceases to be adjusted.

Cash Flow Hedge

IFRS

- Cash flow hedge is a hedge of the exposure to variability in cash flows:

  (i) Attributable to a particular risk associated with a recognized asset or liability or a forecast transaction

  (ii) Could affect profit or loss

- Forecast transaction - Uncommitted but anticipated cash flow hedge accounting can be applied only if it is highly probable.

Note:
It is important to distinguish between forecast transactions and firm commitments as forecast transactions are always cash flow hedged, whereas firm commitments are generally fair value hedged

Cash flow hedge

IFRS

Common assets and liabilities and forecast transactions that are cash flow hedged include:

variable rate liabilities like loans;

variable rate assets like investments in bonds;

highly probable future issuance of fixed rate debt;

forecast reinvestment of interest and principal received on fixed rate assets; and

highly probable forecast sales and purchases.

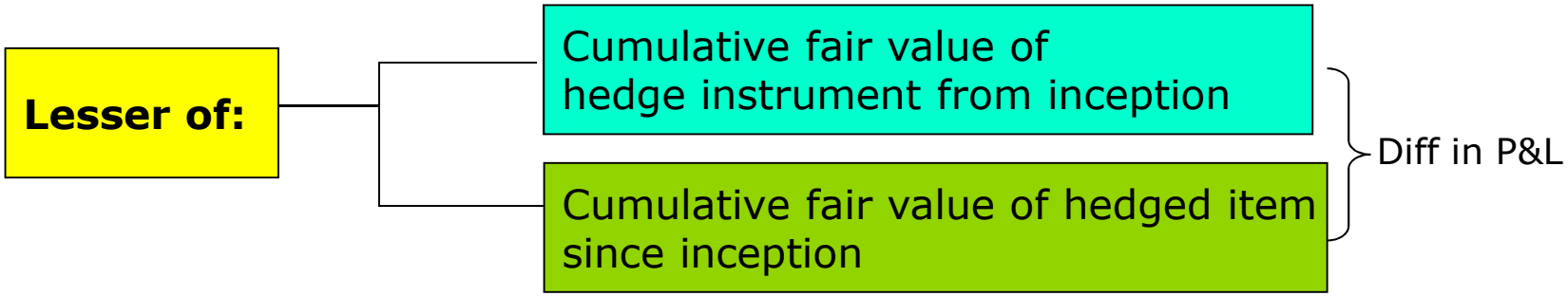
Cash Flow Hedge - Accounting Mechanism

IFRS

A cash flow hedge (assuming it meets all other hedge accounting requirements) is accounted for as follows:
a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognized directly in equity through the statement of changes in equity; and
(b) the ineffective portion of the gain or loss on the hedging instrument is recognized immediately in profit or loss.

Accounting:

Gain / loss on hedged item is deferred in equity as follows:



Hedge Accounting-basis Adjustment

IFRS

Accounting Policy Choice:

(i) Adjust changes in hedged risk to the carrying amount of asset / liability; or

(ii) Recognize in profit or loss when the hedged item effects profit or loss

For example: if hedged item is the firm commitment for purchase of an equipment the derivative asset/ liability can either be adjusted to the carrying amount of the equipment or recognized in profit or loss when depreciation is recognized in profit or loss.

Cash flow hedge

IFRS

Discontinuance of cash flow hedge accounting when :

a. Hedging instrument expires or sold or terminated or exercised

Accounting: Derecognize the instrument and cumulative gains or losses recycled when profit or loss is impacted by the hedged item

b. The hedge no longer meets the hedging accounting criteria

Accounting: Instrument MTM and cumulative gains or losses recycled when profit or loss is impacted by the hedged item

c. The entity de-designates the hedging relationship

Accounting: Same as (b) above

Cash flow hedge

IFRS

Discontinuance of cash flow hedge accounting when :

d. Forecast transaction is no longer highly probable but still expected to occur

Accounting: Same as (b) above

e. Forecast transaction is no longer expected to occur

Accounting: Continue MTM of the instrument and recycle to P&L the amount accumulated in the equity

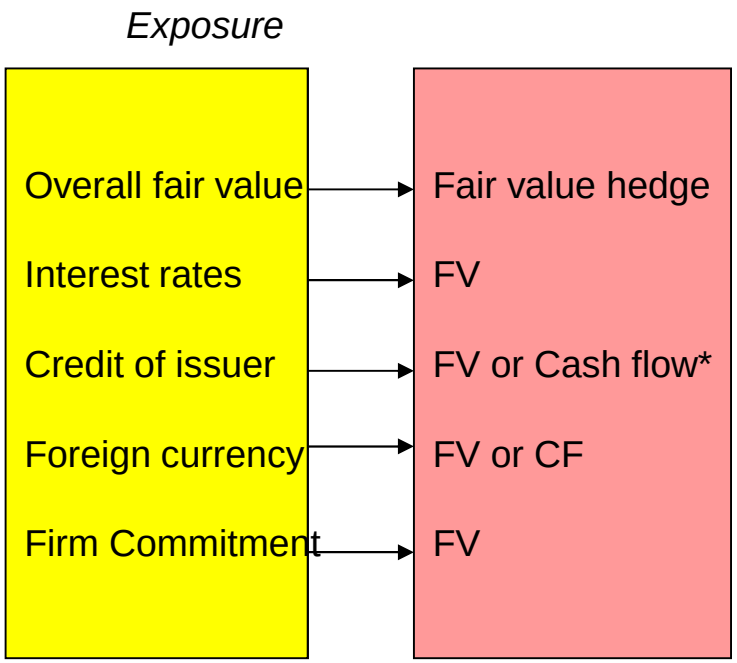
f. Variability of cash flows ceases

Accounting: Same as (b) above

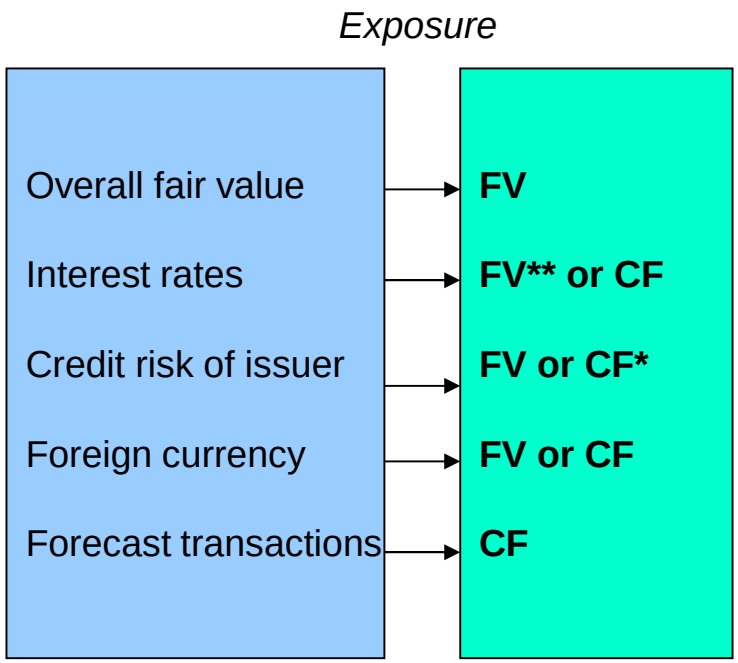
Hedge Accounting-exposures And Type Of Hedges

IFRS

Fixed Rate Assets and Liabilities:



Variable Rate Assets and Liabilities:



*applies when credit spread is variable ** permitted if interest fixed at reset dates

Hedge accounting criteria

IFRS

1. Formal designation and documentation of hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.

2. Hedge expected to be highly effective

3. Forecast transactions is highly probable

4. Effectiveness can be reliably measured

5. Hedge is assessed on an on going basis and determined actually to have been highly effective throughout the financial reporting periods for which hedge was designated.

Hedge Accounting-documentation

IFRS

Always at inception of hedge:

- Risk management policies
- Hedge instrument
- Hedged risk
- Hedge type – fair value or cash flow
- Date of designation
- Details of hedged instrument – start and maturity date, notional, resets
- Details of hedged item
- Effectiveness testing – method
- Results of prospective and retrospective effectiveness testing
- Policy for basis adjustment
- Reconciliation of gain/loss deferred in equity

Hedge Accounting-effectiveness

IFRS

Highly effective = expected to offset changes in fair value or cash flows of hedged risk during the hedge period

To qualify for hedge accounting hedge should be highly effective on

(i) Inception

(ii) Prospectively

(iii) Retrospectively

Best for short-term hedge. Easy to compute. Not appropriate for Indirect hedge

Measures relationship Between dependent and independent Variables; or between 2 variables. Suitable for indirect hedge relationships-oil using futures

Methods to test : Ratio analysis, Regression analysis

The actual results of the hedge should always be within the range 80-125 percent

Hedge Accounting-ineffectiveness

IFRS

(i) Fair value hedge – any ineffectiveness automatically recognized in profit or loss as changes in fair value of hedged instrument is recognized in profit or loss

(ii) Cash flow hedge – amount deferred in equity is lower of:

a. the cumulative gain or loss on hedge instrument since inception; and

b. the cumulative fair value change in expected cash flows from inception

Hedge Accounting-effectiveness

IFRS

(i) Effectiveness test required to be performed on inception and on a "prospective" and "retrospective" basis at each reporting date either on a period-on-period basis or cumulative. Reporting date includes interim reports.

Effectiveness within 80-125 percent range but not 100 percent:

Deviation from 100 percent means ineffective relationship and the ineffective portion should be recognized in profit or loss

Effectiveness outside 80-125 percent range: discontinue hedge accounting

Option to re-designate the hedge but as a new "hedge" relationship

Hedge Accounting-effectiveness

IFRS

(i) Principal of hedged risk and hedge instrument

If principal terms match there is likely to be a high degree of offset between the hedged item and the hedge instrument.

Matching of principal terms cannot lead to an assumption that the hedge is effective. Quantitative tests must be performed to demonstrate effectiveness.

Hedge Accounting-effectiveness

IFRS

(i) Example of principal terms:

Interest rate risk : Notional of derivative should match the principal terms of the interest bearing asset/liability

Derivative in on-market at inception and has fair value of zero

Formula for computing net settlement is the same for the entire term

Other features for eg, prepayment options should be considered

Section V - Presentation

Agenda

IFRS

- Objective
- IAS 32 Key Definitions
- Equity/Liability Classification
- Compound Instruments and Split Accounting
- Treasury Shares
- Offsetting

Objective

IFRS

Learning Objective — To explain the basic principles in IAS 32

IAS 32:

- Clarifies the classification of a financial instrument issued by an enterprise as a liability or as equity
- Describes the accounting for treasury shares (a company's own repurchased shares)
- Prescribes strict conditions under which financial assets and financial liabilities may be offset in the balance sheet

IFRS

IAS 32 Key Definitions

IAS 32 Key Definitions

IFRS

Financial Instrument: A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial Asset: Any asset that is:

- Cash
- Equity instrument of another entity
- Contractual right to receive or exchange cash or assets
- A contract that will or may be settled in the entity's own equity instruments

Financial Liability: Any liability that is:

- A contractual obligation to deliver or exchange cash or financial asset
- A contract that will or may be settled in the entity's equity instruments

Equity Instrument: Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities

Fair Value: The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction

IFRS

Equity/Liability Classification

Equity/Liability Classification

IFRS

Substance Over Form

Classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset, or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset, and an equity instrument.

Split Accounting

If a financial instrument contains both a liability and an equity element, the instrument's component parts should be classified separately.

Liability Classification

IFRS

Contractual obligation to deliver cash or another financial asset

- Mandatory redeemable preference shares
- An instrument puttable by the holder
  - February 2008 amendment to IAS 32 will reflect certain puttable instruments as equity.

Contingent Settlement Provisions

IFRS

Contingent settlement provision

- Liability: if the obligation to deliver cash or another financial instrument arises on the occurrence or nonoccurrence of uncertain future events that are beyond the control of both the issuer and holder, unless:
  - The settlement is only required in the event of a liquidation of the issuer; or
  - The contingent event that triggers the obligation is considered to be not genuine.
- Examples include instruments that require redemption depending on taxation requirements or the issuer's earnings or debt/equity ratio.
- February 2008 amendment to IAS 32 will reflect certain contingently puttable instruments as equity.

February 2008 Amendment to IAS 32

IFRS

Puttable instruments are classified as equity if they meet ALL the following requirements:

- The holder is entitled to a pro rata share of the net assets at liquidation.
- The instrument is in the class of instruments that is most subordinate and all instruments in the class are identical.
- The instrument has no other characteristics of a financial liability.
- The total expected cash flows attributable to the instrument over its life are based substantially on earnings or the change in net assets.

Examples: Some mutual fund, cooperative, and partnership interests

Equity Classification

IFRS

Equity arises in two circumstances:

- No contractual obligation to deliver cash or financial assets
- If settlement is with own shares, it is:
  - Settled with fixed number of shares, or
  - Settled with fixed number of shares for fixed amount of cash

With variable number of shares, cannot be equity → classify as liability

Temporary Equity

IFRS

Unlike U.S. SEC requirements, there is no mezzanine equity section under IFRS.

As noted previously, contingently redeemable shares are generally liabilities under IAS 32.

Classification Examples under IAS 32

IFRS

Instrument	*Classification*
Common shares	Equity
Mandatorily redeemable instruments	Liabilities*
Instruments redeemable at the option of the holder	Liabilities*
Puttable instruments	Liabilities*
Instruments with contingent settlement provisions	Liabilities (unless nonsubstantive provision)*
Obligation to issue shares worth a fixed or determinable amount	Liability
Convertible debt	Compound instrument
Perpetual debt	Liability

*Certain Exceptions

Case Study 1

IFRS

For each of the below financial instruments issued by Entity A during 2007, discuss whether it should be classified as a financial liability under IAS 32 and, if so, why?

1. A perpetual bond (i.e., a bond that does not have a maturity date) that pays 5% interest each year
2. A mandatorily redeemable share (i.e., a share that will be redeemed by the entity at a future date)
3. A share that is redeemable at the option of the holder
4. A sold (written) call option that allows the holder to purchase a fixed number of ordinary shares from Entity A for a fixed amount of cash

Case Study 1 — Solution

IFRS

1. An issued perpetual bond (i.e., a bond that does not have a maturity date) that pays 5% interest each year should be classified as a financial liability. Because the instrument is essentially redeemed through the payment of interest, it meets the definition of a financial liability.
2. An issued mandatorily redeemable share (i.e., a share that will be redeemed by the entity at a future date) should be classified as a financial liability. Because the instrument contains an obligation to pay cash or other financial assets on redemption of the share, it meets the definition of a financial liability.
3. An issued share that is redeemable at the option of the holder should be classified as a financial liability. Because the entity cannot avoid settlement through delivery of cash should the holder demand redemption, the share meets the definition of a financial liability.
4. A sold (written) call option that allows the holder to purchase a fixed number of ordinary shares from Entity A for a fixed amount of cash should be classified as equity. A contract that will or may be settled in own equity is classified as equity if it provides for the exchange of a fixed number of own equity instruments for a fixed amount of cash.

IFRS

Compound Instruments and Split Accounting

Compound Instruments

IFRS

A compound instrument is an issued single financial instrument that contains both a liability and an equity element.

Example: Convertible bond

- An entity issues a bond that pays interest and that grants the holder the right to convert the bond into an equity instrument of the issuer.

“Split accounting”:

- The obligation to pay interest and principal is a liability.
- The equity conversion option is equity.

Split Accounting

IFRS

Method of separation

- Use initial carrying amount of compound instrument as your starting point.
- Determine fair value of the liability element.
- Allocate the residual amount to the equity element.

Example

- ABC Corp. issues convertible debt for proceeds of 100.
- ABC estimates fair value of conversion option to be 12.
- ABC estimates present value of contractual cash flows to be 90.

Answer:

- Allocate 90 to liabilities and residual of 10 to equity.

Case Study 2 — Convertible Debt

IFRS

Background

- A company issues bonds together with warrants to subscribe for ordinary shares of the company.

Assume the following:

• Face value of bonds	CU15 million
• Issue price of bonds	CU15 million
• Fair value of bonds only	CU12 million
• Fair value of warrants issued	CU3.2 million
• Coupon rate	1.0% p.a.

Case Study 2 — Convertible Debt (cont'd)

IFRS

	Yr 1	Yr 2	Yr 3
Amortization of discount ($3M)	$921,379	$997,883	$1,080,738
Interest coupon (1% x $15M)	$150,000	$150,000	$150,000
Total interest expense	$1,071,379	$1,147,883	$1,230,738

	Inception	End-Yr 1	End-Yr 2	End-Yr 3
Carrying amount of loan (liability component)	$12,000,000	$12,921,379	$13,919,262	$15,000,000

Case Study 2 — Convertible Debt (cont'd)

IFRS

Recording of the convertible debt on transaction date:

Dr	Cash	15,000,000		
	Cr	Debt		(12,000,000)
	Cr	Equity		(3,000,000)

At end of 1st year:

Dr		Interest expense	1,071,379	
	Cr	Debt		(921,379)
	Cr	Cash		(150,000)

IFRS

Treasury Shares

Treasury Shares

IFRS

No gain or loss is recognized on the purchase, sale, issue, or cancellation of treasury shares.

Similar to U.S. GAAP, treasury shares are not treated as assets, but deducted from equity.

IFRS

Offsetting

Offsetting

IFRS

A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:

- Currently has a legally enforceable right to set off the recognized amounts; and
- Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

Unlike U.S. GAAP (FIN 39/FIN 41):

- Offsetting is not elective under IAS 32
- There is no exception from the intent requirement in IAS 32 for derivatives or repos subject to master netting agreements

Section VI - Disclosures

Yogesh Sharma

IFRS 7: Objectives

IFRS

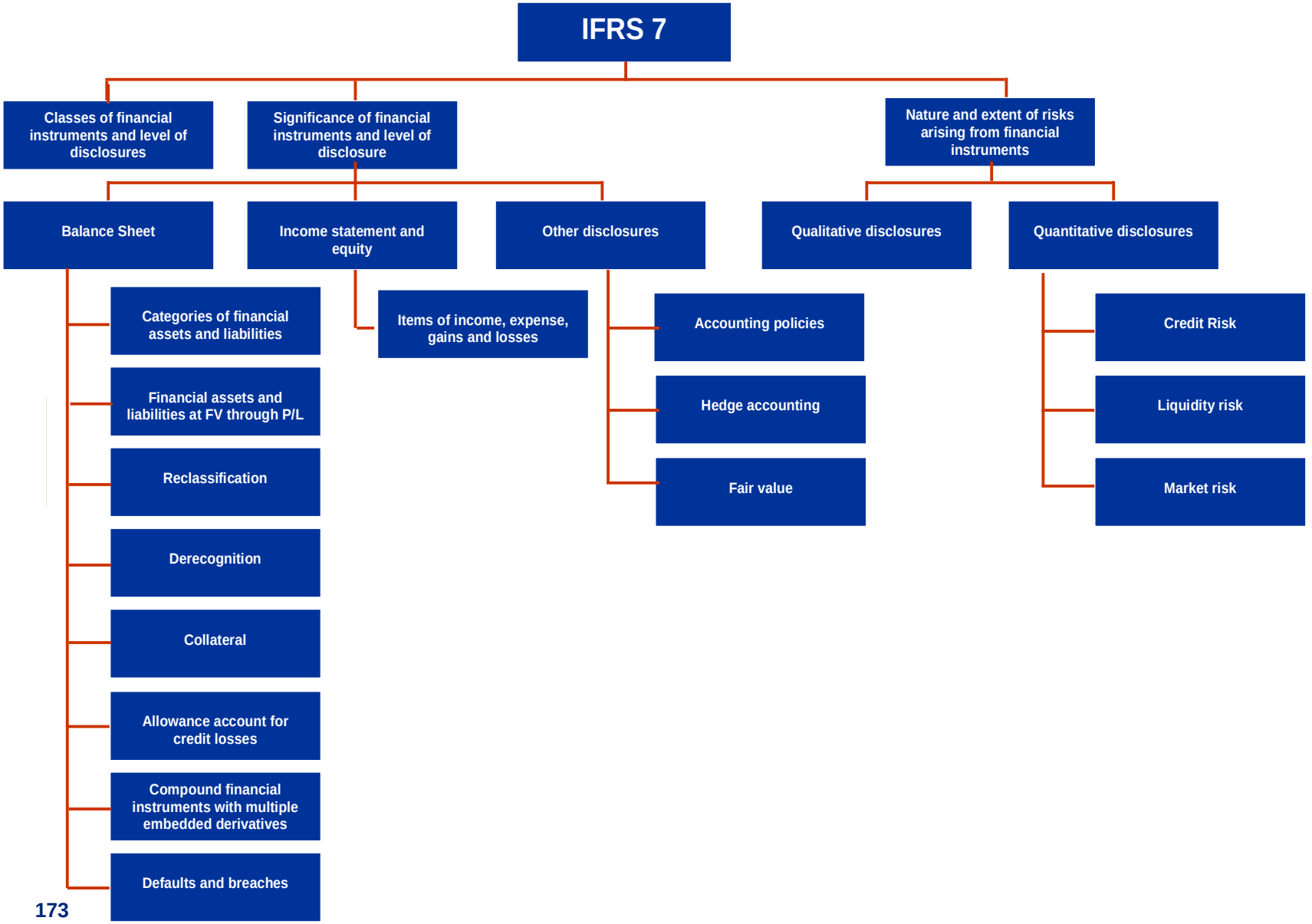
To provide disclosures to evaluate:

The **significance of financial instruments** for the entity's financial position and performance; and

The **nature and extent of risks arising from financial instruments** to which the entity is exposed during the period and at the reporting date, and **how the entity managed those risks**

IFRS 7: Disclosure requirements

IFRS



IFRS 7 Disclosure requirements - FVTPL

IFRS

If designating a Financial liability as at FVTPL, shall disclose:

Change in the fair value of the financial liability that is attributable to changes in the credit risk during the period and cumulatively

Difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation

FV Changes attributable to credit risk

IFRS

On 1 January 20X1, an entity issues a 10-year bond with a par value of CU150,000 and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics

The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 per cent. At the end of the first year:

(a) LIBOR has decreased to 4.75%

(b) the fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent.

Assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions

FV Changes attributable to credit risk

IFRS

Step 1: Segregate the total rate of return into:

Observable (benchmark) interest rate => 5%

Instrument specific rate of return => 3%

Step 2: Calculate the present value of cash flows based on benchmark interest rate as at reporting date (4.75%) and the instrument specific rate of return under Step 1 (3%) => 7.75%, PV = CU152,367

Step 3: Disclose CU1,444 (CU153,811-CU152,367), as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk

Example - Disclosure of financial liabilities designated at fair value

IFRS

26 Financial liabilities designated at fair value

HSBC

	2005 US$m
Deposits by banks and customer accounts	253
Liabilities to customers under investment contracts	10,445
Debt securities in issue (Note 27)	28,338
Subordinated liabilities (Note 31)	18,447
Preference shares (Note 31)	4,346
	61,829

The carrying amount at 31 December 2005 of financial liabilities designated at fair value was US$1,899 million higher than the contractual amount at maturity. At 31 December 2005, the accumulated amount of the change in fair value attributable to changes in credit risk was US$664 million.

HSBC Holdings

	2005 US$m
Subordinated liabilities (Note 31):	
– owed to third parties	9,315
– owed to HSBC undertakings	4,055
	13,370

The carrying amount at 31 December 2005 of financial liabilities designated at fair value was US$910 million higher than the contractual amount at maturity. At 31 December 2005, the accumulated amount of the change in fair value attributable to changes in credit risk was US$398 million.

Allowance for credit losses

IFRS

Allowance account for credit losses

When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g., an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset

Disclose a reconciliation of changes in that account during the period for each class of financial assets

Example - Disclosure of movement of allowance account

IFRS

Movement in allowance accounts for total loans and advances

(Audited IFRS 7 information)

	2005		
	Individually assessed US$m	Collectively assessed US$m	Total US$m
At 1 January			12,881
IFRSs transition at 1 January			(247)
At 1 January	3,728	8,906	12,634
Amounts written off	(1,102)	(7,941)	(9,043)
Recoveries of loans and advances written off in previous years	199	295	494
Charge to income statement	518	7,342	7,860
Exchange and other movements	(664)	85	(579)
At 31 December	2,679	8,687	11,366

Impairment allowances against loans and advances to customers

	2005 %	2004 %
Total impairment allowances to gross lending[1]		
Individually assessed impairment allowances	0.36	–
Collectively assessed impairment allowances	1.18	–
Total provisions to gross lending[1]		
Specific provisions	–	1.56
General provisions	–	0.39
	1.54	1.95

1 *Net of reverse repo transactions and settlement accounts.*

Nature & extent of risks arising from financial instruments

IFRS

Market risk	**The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises of currency risk, interest rate risk and other price risk**
(i) Currency risk	**The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates**
(ii) Interest rate risk	**The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates**
(ii) Other price risk	**The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk)**

Nature & extent of risks arising from financial instruments

IFRS

Credit risk	**The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation**
Liquidity risk	**The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities**

Nature & extent of risks arising from financial instruments

IFRS

Qualitative disclosures:

For each type of risk arising from financial instruments, an entity shall disclose:

(a) the exposures to risk and how they arise;

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) any changes in (a) or (b) from the previous period

Nature & extent of risks arising from financial instruments

IFRS

Quantitative disclosures:

For each type of risk arising from financial instruments, an entity shall disclose:

(a) summary quantitative data about its exposure to that risk at the reporting date. This disclosure shall be based on the information provided internally to key management personnel of the entity, for example the entity's board of directors or chief executive officer

(b) the disclosures required by IFRS 7.36–42 (credit/liquidity/market risks), to the extent not provided in (a), unless the risk is not material

(c) concentrations of risk if not apparent from (a) and (b)

Nature & extent of risks arising from financial instruments – credit risk

IFRS

Quantitative disclosures – Credit Risk:

An entity shall disclose by class of financial instrument:

the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (e.g., netting agreements that do not qualify for offset in accordance with IAS 32);

in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancements;

information about the credit quality of financial assets that are neither past due nor impaired; and

the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated

Example - Disclosure of credit quality of financial assets

IFRS

Credit quality

Loans and advances

Distribution of loans and advances by credit quality *(Audited IFRS 7 information)*

	At 31 December 2005	
	Loans and advances to customers US$m	Loans and advances to banks US$m
Loans and advances:		
– neither past due nor impaired	731,116	125,930
– past due but not impaired	8,797	22
– impaired	11,446	22
	751,359	125,974

Example - Disclosure of financial assets not past due nor impaired

IFRS

Distribution of loans and advances neither past due nor impaired *(Audited IFRS 7 information)*

The credit quality of the portfolio of loans and advances that were neither past due nor impaired at 31 December 2005 can be assessed by reference to the Group's standard credit grading system. The following information is based on that system:

	Loans and advances to customers US$m	Loans and advances to banks US$m
Grades:		
1 to 3 – satisfactory risk	705,036	125,324
4 – watch list and special mention	19,950	555
5 – sub-standard but not impaired	6,130	51
	731,116	125,930

Grades 1 and 2 include corporate facilities demonstrating financial condition, risk factors and capacity to repay that are good to excellent, residential mortgages with low to moderate loan to values ratios, and other retail accounts which are not impaired and are maintained within product guidelines.

Grade 3 represents satisfactory risk and includes corporate facilities that require closer monitoring, mortgages with higher loan to value ratios than grades 1 and 2, all non-impaired credit card exposures, and other retail exposures which operate outside product guidelines without being impaired.

Grades 4 and 5 include corporate facilities that require various degrees of special attention and all retail exposures that are progressively between 30 and 90 days past due.

Example - Disclosure of financial assets past due but not impaired

IFRS

Loans and advances which were past due but not impaired *(Audited IFRS 7 information)*

Loans and advances which were past due at 31 December 2005 but not impaired were as follows:

	Loans and advances to customers US$m	Loans and advances to banks US$m
Past due up to 29 days	4,837	22
Past due 30 – 59 days	1,743	–
Past due 60 – 89 days	583	–
	7,163	22
Past due 90 – 179 days	1,368	–
Past due over 180 days but less than 1 year	266	–
	8,797	22

This ageing analysis includes loans and advances less than 90 days past due that have collective impairment allowances set aside to cover credit losses on loans which are in the early stages of arrears.

There are a variety of reasons why certain loans designated as 'past due' are not regarded as impaired. Unless other information is available to indicate to the contrary, all loans less than 90 days past due are not considered impaired. It is also not unusual for short-term trade finance facilities to extend beyond 90 days past due for reasons that do not reflect any concern on the creditworthiness of the counterparty, such as delays in documentation. In addition, past due loans secured in full by cash collateral are not considered impaired and, where appropriate, neither are residential mortgages in arrears by more than 90 days where the value of collateral is sufficient to repay both the debt and all potential interest for at least one year.

Nature & extent of risks arising from financial instruments – Liquidity risk

IFRS

Quantitative disclosures – Liquidity Risk:

An entity shall disclose:

(a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and

(b) a description of how it manages the liquidity risk inherent in (a)

Nature & extent of risks arising from financial instruments

IFRS

Quantitative disclosures – Liquidity Risk:

In preparing the contractual maturity analysis for financial liabilities, an entity uses its judgment to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

not later than one month;
later than one month and not later than three months;
later than three months and not later than one year; and
later than one year and not later than five years

Nature & extent of risks arising from financial instruments

IFRS

Quantitative disclosures – Market Risk:

<u>Sensitivity analysis – para 40</u>

Unless an entity complies with para 41 (next slide), it shall disclose:

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

(b) the methods and assumptions used in preparing the sensitivity analysis; and

(c) changes from the previous period in the methods and assumptions used, and the reasons for such changes

Nature & extent of risks arising from financial instruments

IFRS

Quantitative disclosures – Market Risk:

<u>Sensitivity analysis – para 41</u>

If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g., interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in para 40. The entity shall also disclose:

an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and

an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved

Nature & extent of risks arising from financial instruments

IFRS

Quantitative disclosures – Market Risk:

Para 40(a) …*showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date*;

not required to determine what the profit or loss for the period would have been if relevant risk variables had been different

Instead, entities disclose the effect on profit or loss and equity at the balance sheet date assuming that a reasonably possible change in the relevant risk variable had occurred at the balance sheet date and had been applied to the risk exposures in existence at that date

For example, if an entity has a floating rate liability at the end of the year, the entity would disclose the effect on profit or loss (i.e., interest expense) for the current year if interest rates had varied by reasonably possible amounts

Nature & extent of risks arising from financial instruments

IFRS

Quantitative disclosures – Market Risk:

Sensitivity analysis on interest rate risk:

For example, assume that interest rates are 5 per cent and an entity determines that a fluctuation in interest rates of ±50 basis points is reasonably possible

It would disclose the effect on profit or loss and equity if interest rates were to change to 4.5 per cent or 5.5 per cent

In the next period, interest rates have increased to 5.5 per cent. The entity continues to believe that interest rates may fluctuate by ±50 basis points (i.e., that the rate of change in interest rates is stable). The entity would disclose the effect on profit or loss and equity if interest rates were to change to 5 per cent or 6 per cent

The entity would not be required to revise its assessment that interest rates might reasonably fluctuate by ±50 basis points, unless there is evidence that interest rates have become significantly more volatile

Nature & extent of risks arising from financial instruments

IFRS

Interest rate risk

At 31 December 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant, post-tax profit for the year would have been CU1.7 million (20X1—CU2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings, and other components of equity would have been CU2.8 million (20X1—CU3.2 million) higher, arising mainly as a result of an increase in the fair value of fixed rate financial assets classified as available for sale. If interest rates had been 10 basis points higher, with all other variables held constant, post-tax profit would have been CU1.5 million (20X1—CU2.1 million) lower, arising mainly as a result of higher interest expense on variable borrowings, and other components of equity would have been CU3.0 million (20X1—CU3.4 million) lower, arising mainly as a result of a decrease in the fair value of fixed rate financial assets classified as available for sale. Profit is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X).

Nature & extent of risks arising from financial instruments

IFRS

Foreign currency exchange rate risk

At 31 December 20X2, if the CU had weakened 10 per cent against the US dollar with all other variables held constant, post-tax profit for the year would have been CU2.8 million (20X1—CU6.4 million) lower, and other components of equity would have been CU1.2 million (20X1—CU1.1 million) higher. Conversely, if the CU had strengthened 10 per cent against the US dollar with all other variables held constant, post-tax profit would have been CU2.8 million (20X1—CU6.4 million) higher, and other components of equity would have been CU1.2 million (20X1—CU1.1 million) lower. The lower foreign currency exchange rate sensitivity in profit in 20X2 compared with 20X1 is attributable to a reduction in foreign currency denominated debt.

IFRS

Questions

Thank you