香 港 會 計 師 公 會
HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)
香 港 金 鐘 道 八 十 九 號 力 寶 中 心 二 座 四 樓
4th Floor, Tower Two, Lippo Centre, 89 Queensway, Hong Kong.
Tel: 2287 7228 Fax: 2865 6603 / 2865 6776 Web: http://www.hksa.org.hk E-mail: hksa@hksa.org.hk

Press Release
新 聞 稿

To: News/Business Editor, 2 June 2004
(For immediate release)

# HKSA Issues Standards on Financial Instruments

The **Hong Kong Society of Accountants** (HKSA) has today issued two Standards dealing with financial instruments. HKAS 32 deals with the disclosure of financial instruments and their classification as debt or equity. HKAS 39 deals with recognition, derecognition, measurement and hedge accounting. These two Standards are based on the international accounting standards issued by the International Accounting Standards Board (IASB). They are to be applied prospectively for accounting periods beginning on or after 1 January 2005 with earlier application prohibited.

These two accounting standards provide comprehensive guidance on the accounting for financial instruments. The need for such guidance is crucial. Financial instruments are a large part of the assets and liabilities of virtually every company, in particular financial institutions. They also play a central role in the efficient operation of financial markets.

Financial instruments, including derivatives, can be useful tools for managing risk. But they can also be very risky themselves. The Standards require companies to disclose their exposure to financial instruments and to account for their effects in most cases as they happen, rather than allowing problems to be hidden away. In particular, HKAS 39 requires derivatives to be reported at their fair or market value, rather than at cost. This overcomes the problem that the cost of a derivative is often nil or immaterial and hence, if derivatives are measured at cost, they are often not included in the balance sheet at all and their success (or otherwise) in reducing risk is not visible. In contrast, measuring derivatives at fair value ensures that their leveraged nature and their success (or otherwise) in reducing risk are reported.

A brief summary of the contents of HKAS 32 and HKAS 39 is attached as a note to this press release.

In April 2004, the IASB published an exposure draft of a proposed limited amendment to IAS 39 (on which HKAS 39 is based) with a comment deadline of 21 July 2004. This exposure draft proposes to limit the financial assets and financial liabilities to which the fair value option may be applied. In Hong Kong, an invitation to comment on this exposure draft was issued concurrently. The HKSA's Financial Accounting Standards Committee (FASC) intends to recommend the adoption of a similar amendment following from the IASB's final approved amendment. In order to allow entities sufficient time to understand and implement the Standards, the HKSA decided not to delay the issue of these Standards for this one specific amendment. However, a limited amendment to HKAS 39 will be made, probably before the end of 2004, once the IASB's proposed amendment to IAS 39 in respect of the Fair Value Option is finalised.

Commenting on the two Standards, **Mr. Paul F. Winkelmann**, Chairman of the Society's Financial Accounting Standards Committee said: "Accounting for financial instruments has always been considered controversial due to their nature. The new Standards should help standardise the presentation, recognition and measurement of financial instruments and improve their disclosure in accounts." He also said that: "Upon the release of these two Standards, we are getting very close to meeting our objective of achieving full convergence with International Accounting Standards. To require the accounting for financial instruments to be at par with international counterparts is important for Hong Kong as one of the major financial centres. "

The two Standards are available on the HKSA website at: http://www.hksa.org.hk/professionaltechnical/accounting/standards/.

– End –

The HKSA is the only statutory licensing body of accountants in Hong Kong responsible for the regulation of the accounting profession, with a membership of over 22,000 and close to 11,000 registered students.

Issued by the HKSA. For further information, please contact the following:

Ms. Florence Chan
Assistant Director – Public Relations
Direct line : 2287 7036
Mobile : 9877 2915
Fax no. : 2865 6776
Email : fchan@hksa.org.hk

Ms. Cynthia Lee
Administrative Officer - Public Relations
Direct line : 2287 7002
Mobile : 9322 3456
Fax no. : 2865 6776
Email : cynthialee@hksa.org.hk

**Note: Financial Instruments - An introduction to HKAS 32 and HKAS 39**

| |
|---|
| *This brief introduction summarises and comments on the requirements of HKAS 32 and HKAS 39, and the background to them. It is not intended to be as comprehensive or precise as the standards themselves, and is not a substitute for them.* |

***What are HKAS 32 and 39 all about?***

HKAS 32 deals with the **disclosure** of financial instruments, and with some aspects of their **presentation** in financial statements (i.e. when instruments are presented as liability or equity and the information to be given in the notes).

HKAS 39 deals with the **measurement** of financial instruments and with their **recognition** (i.e. when they should be included in financial statements and how they should be valued).

***Why do we need standards on financial instruments?***

Financial instruments are an important part of the assets and liabilities of many companies, especially financial institutions. They also play a central role in the efficient operation of financial markets.

Financial instruments, including derivatives, can be useful tools for managing risk, but they can also be very risky themselves. In recent years there have been many disasters associated with derivatives and other financial instruments.

The standards require companies to disclose their exposure to financial instruments and to account for their effects in most cases as they happen, rather than allowing problems to be hidden away.

***What companies do the standards apply to?***

The standards apply to all companies reporting under Hong Kong Financial Reporting Standards (HKFRS).

***What financial instruments do the standards apply to?***

Broadly, the standards apply to all financial instruments except:

- Those covered by another more specific standard such as interests in subsidiaries, associates and joint ventures, and post-employment benefits (e.g. pensions);
- Insurance contracts, and certain contracts that are similar in nature to insurance contracts; and
- Most loan commitments.

The standards also apply to contracts to buy or sell a non-financial item (such as commodity contracts) where these are not for the entity's own purchase, sale or usage requirements, but for dealing purposes.

***What are the main requirements of HKAS 32?***

Disclosure

HKAS 32 requires disclosure of information to increase users understanding of why financial instruments are used by businesses and the associated risks. This includes information on:

- The risks associated with the entity's financial instruments
- Management's policies for controlling those risks
- The accounting policies applied to the instruments
- The nature and extent of an entity's use of financial instruments
- The business purposes they serve

Issuer's need to consider presentation as either debt or equity

HKAS 32 adopts definitions of liabilities and equity based on the *Framework for the Preparation and Presentation of Financial Statements*, which provides

- A financial instrument is a liability if it is a contractual obligation to deliver cash or other financial assets. The finance cost of liabilities is accounted for as an expense.
- A financial instrument is equity if it evidences a residual interest in the assets of an entity after deducting all of its liabilities. Payments on equity are treated as distributions, not as expenses.
- Convertible debt (that gives the holder a choice of repayment in cash or in shares) is separated into its debt and equity components. More specifically, it is analysed into an issue of ordinary debt at a discount, and a credit to equity for the conversion right.

As well as ordinary debt, liabilities include mandatorily redeemable shares, such as units of a mutual fund and some preferred shares, because they contain an obligation to pay cash.

Offsetting

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

- Has a current right to set off the recognised amounts; and
- Intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Situations that generally do not qualify for offsetting include master netting agreements, where there is no intention to settle net, and so-called in-substance defeasance arrangements where assets are set aside to meet a liability but the entity remains primarily liable.

***What are the main requirements of HKAS 39?***

<u>Measurement</u>

HKAS 39 divides financial assets and financial liabilities into five classes with three different accounting treatments, as follows:

- Trading assets and liabilities, including all derivatives that are not hedges, are measured at fair value. All gains and losses are recognised in profit or loss as they arise;

- Loans and receivables are ordinarily accounted for at amortised cost, as are most liabilities;

- Held-to-maturity investments are also accounted for at amortised cost;

- All other financial assets are ordinarily classified as available-for-sale and measured at fair value, with all gains and losses taken to equity. On disposal, gains and losses previously taken to equity are recycled to profit or loss;

- There is an option to account for any financial asset or liability at fair value through profit or loss.

There are special rules for hedge accounting, described later.

Another aspect of measurement is **impairment** - i.e., when and how losses should be recognised in profit or loss on those assets that are not accounted for at fair value through profit or loss. Whenever there is objective evidence of impairment as a result of a past event, impairment should be recognised. Among other things, the standard clarifies that:

- Impairment should take into account only losses that have already been incurred, and not those that might happen in future;

- Impairment losses on available-for-sale assets are taken from equity and recognised in profit or loss. For equity investments, objective evidence of impairment may include significant adverse changes in the issuer's market position, or a significant or prolonged decline in the fair value of the investment.

<u>Hedge accounting</u>

HKAS 39 describes two main kinds of hedging relationship and their accounting treatment:

- *A fair value hedge* in which the <u>fair value</u> of the item being hedged changes as market prices change. Changes in the fair value of both the hedging instrument and the hedged item are reported in profit or loss;

- *A cash flow hedge* in which the <u>cash flows</u> of the item being hedged change as market prices change. Changes in the fair value of the hedging instrument are initially reported in equity and transferred to profit or loss to match the recognition of the offsetting gains and losses on the hedged transaction.

It specifies that a hedge of a net investment in a foreign operation is to be accounted for in the same way as a cash flow hedge. It allows fair value hedging for a portfolio hedge of interest rate risk (a macro hedge).

Hedge accounting allows entities to depart selectively from the normal accounting treatment and allows losses to be held back or gains to be accelerated. Therefore the following principles have been adopted in order to provide discipline over the use of hedge accounting, and ensure that entities do not have free choice over when to recognise gains and losses:

- The hedging relationship has to be defined by designation and documentation, reliably measurable, and actually effective;

- To the extent that a hedging relationship is effective, the offsetting gains and losses on the hedging instrument and the hedged item are recognised in profit or loss at the same time;

- All hedge ineffectiveness is recognised immediately in profit or loss;

- Only items that meet the definitions of assets and liabilities are recognised as such in the balance sheet.

Hedge accounting for internal hedges is not permitted, because internal transactions are eliminated on consolidation the entity is merely dealing with itself. However, internal hedges are often used as a route to the market, via an internal treasury centre. HKAS 39 clarifies what needs to be done in order to achieve hedge accounting in this case.

***What are the transitional arrangements?***

These Standards are to be applied prospectively for accounting periods beginning on or after 1 January 2005 with earlier application prohibited. Entities will be adopting IFRS for the first time in 2005. The most significant transitional arrangements for them are:

- Non-derivative financial assets and financial liabilities that were derecognised prior to 1 January 2005 remain derecognised. This gives a safe harbour for securitisation and other transactions that have led to derecognition in the past;

- Comparative information for the first accounting period beginning on or after 1 January 2005 (i.e. on first adoption for those entities already reporting in accordance with HKFRS) need not comply with HKAS 32 and 39;

- Adjustments are made to the opening balance sheet at the date of first compliance, in order to measure all recognised financial assets and financial liabilities in accordance with HKAS 39;

- Entities can designate financial instruments as at fair value through profit or loss or available-for-sale on the date they first comply with HKAS 32 and 39;

- Existing hedges are eligible for hedge accounting only if they are properly designated and documented as such no later than the date of first compliance, and otherwise qualify for hedge accounting under HKAS 39.

***Future changes***

The IASB has published an Exposure Draft of a proposed limited amendment to IAS 39 *Financial Instruments: Recognition and Measurement* on The Fair Value Option.

The Exposure Draft proposes to limit the financial assets and financial liabilities to which the fair value option may be applied, while preserving the key benefits of the option. In particular, the proposals are to:

(a) Limit the types of financial assets and financial liabilities to which the option may be applied to five specified categories, and

(b) Require that the option may be applied only to financial assets and financial liabilities whose fair value is verifiable. The proposal that fair value must be verifiable would apply only when the fair value option is used, and not for other items measured at fair value (those classified as held for trading, derivatives and available-for-sale assets) or for the purposes of disclosing fair value.

Under the HKSA's due process for setting accounting standards, the HKSA has issued an Invitation to Comment on the exposure draft with comments requested by 7 July 2004. The Invitation to Comment has been posted on the HKSA's website at:
http://www.hksa.org.hk/professionaltechnical/accounting/exposuredraft/.

Following from the IASB's final approved changes, the FASC intends to recommend the adoption of similar changes so that the HKFRS maintain conformity with the IASB's Standards. The FASC does not intend to issue a specific Hong Kong exposure draft on the matters covered in the IASB exposure draft.