Financial Instruments: Recognition and Measurement (HKAS 39)

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Examples and Cases for Discussion

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Initial Recognition & Measurement

Example

Fair value at Initial Recognition – Low Interest Loan

- Entity A grants a 3-year loan of HK$50,000 to a related party, B, on 1 Jan. 2005 as one kind of financial assistance to support B's operation.
  - A charges B at a interest rate of 2% as A expects the return on B's future operation would be higher.
  - A charges another related party at a current market lending rate of 6%
- Discuss the implication of the loan.

Initial Recognition & Measurement

Example

Fair value at Initial Recognition

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

Measurement after Recognition

Example

Sale of HTM investments

- Entity A has $5,000 bonds in Entity X.
- Its subsidiary, Entity B, sells $2,000 bonds from its HTM portfolio with $5,000 bonds in Entity Y on interim date of 2006 before the bonds will be matured in 2010.
- Since Entity X wants to realise the appreciation in market price of the bonds.
- Discuss the impact on Entity B and Entity A.

Measurement after Recognition

Example

Amortised Cost on Low Interest Loan

- Entity A grants a 3-year loan of HK$50,000 to an important new customer in 1 Jan. 2005
  - The interest rate on the loan is 4%
  - The current market lending rates for similar loans is 6%
- Entity A believes that the future business to be generated with this new customer will lead to a profitable lending relationship.
- On initial recognition, Entity A recognised $47,327 (as calculated below):

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

- Calculate the amortised cost each year end.

Measurement after Recognition

- Lateral had purchased a debt instrument with five years remaining to maturity on 1 Nov. 2003.
- The purchase price and fair value was $30M on that date.
- The instrument will be repaid in 5 years time at an amount of $37.5 million.
- The instrument
  - Carries fixed interest of 4.7% per annum on the principal of $37.5M and
  - Has an effective interest rate of 10% per annum.
- The fixed interest has been received and accounted for but no accounting entry has been made other than the recognition of the original purchase price of the instrument.
- Explains the accounting implication for the year ended 31 Oct 2005.

Measurement – Current or Non-Current

Case

Li & Fung Limited

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

Is it current?

Hedging – Hedging Instruments

Example

Entity A, whose functional currency is the Japanese yen

- has issued 5 million 5-year US$ fixed rate debt.
- owns a 5 million 5-year US$ fixed rate bond which is classified as AFS.

1. Can Entity A designate its US$ liability as a hedging instrument in <u>a fair value hedge</u> of the <u>entire fair value exposure</u> of its US$ bond?

2. Alternatively, can the US$ liability be designated as <u>a fair value hedge or cash flow hedge</u> of the <u>foreign currency component</u> of the bond?

Hedging – Hedged Relationship

Example

Fair Value Hedge

Cash Flow Hedge

Hedge of Net Investment in a Foreign Operation

Determine the classification for the following hedge:

- Entity A has a floating rate bond and enters into an interest rate swap by receiving fixed and paying float
- Entity B has a fixed rate bond and enters into an interest rate swap by receiving float and paying fixed
- Entity C issues a floating rate bond and enters into an interest rate swap by paying fixed and receiving float
- Entity D issues a floating rate bond and buys an interest rate cap

Hedging – Assess Hedge Effectiveness

Example

What should be placed attention on option type hedging instruments, say cap?

- How do we assess the actual hedge effectiveness (cash flow hedge) on
  - interest rate swap (or interest rate cap) ?

Actual results

Retrospective testing

Hedging – Hedge Accounting

Example

Hedge of Forecast Transaction

- Entity A trades in UK mainly in UK Sterling.
  - It expects to purchase a machine for 1 million Euros in one year from 1 May 2006.
  - In order to offset the risk of increases in the Euro rate, Entity A enters into a forward contract to purchase 1 million Euros in 1 year for a fixed amount (£650,000).
  - The forward contract is designated as a Cash Flow Hedge.
  - At inception, the forward contract has a fair value of zero.

- At the year-end of 31 October 2006
  - the Euro has appreciated and the value of 1 million Euros is £660,000.
  - The fair value of the forward contract rises to £10,000.
  - The machine will still cost 1 million Euros so the company concludes that the hedge is 100% effective.