



Financial Instruments LKAS 32, LKAS 39, SLFRS 7

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FINANCIAL INSTRUMENTS

- LKAS 32 - Financial Instruments: Presentation
- LKAS 39 - Financial Instruments: Recognition AND Measurement
- SLFRS 7 - Financial Instruments: Disclosure



Introduction



Overview

LKAS 32

- Presentation
- Categories of financial instruments
- Debt vs Equity

SLFRS 7

- Quantitative and Qualitative disclosures

LKAS 39

- Scope of LKAS 39
- Measurement rules
- Impairment
- Derivative definition
- Embedded derivatives
- Fair Value option
- Derecognition
- Overview of Hedge accounting



Overview: LKAS 32 vs LKAS 39

LKAS 32

- Defines financial: instruments, Financial assets & liabilities; equity derivatives
- Prescriptive rules for distinguishing financial liabilities from equity
- Accounting for compound financial instruments
- Interest, dividends, gains and losses be accounted for consistent with B/S classification
- Accounting for share repurchase and treasury shares
- Prescriptive requirements for offsetting financial asset and financial liability

LKAS 39

- Requires all financial instruments including derivatives to be initially recorded at **fair value**
- Defines embedded derivatives & establishes rules for separating
- Creates four categories of financial instruments
- Each category has own measurement rules including: initial & subsequent measurement, reclassifications, gains and losses & impairment
- Permits hedge accounting provided strict criteria are met
- Prescribes when hedge accounting must be discontinued
- Rules for derecognition of financial instruments

Scope and Definition

What is a Financial Instrument?

Any contract that gives rise to:

Financial Asset

in one enterprise

and

**Financial Liability or
Equity Instrument**

in another enterprise



What is a Financial Asset?

Any asset that is:

- cash
- an equity instrument of another entity
- a contractual right:
 - to receive cash or another financial asset from another entity
 - to exchange financial instruments with another enterprise under conditions that are potentially favorable
- A contract that will or may be settled in the entity's own equity instrument and is:
 - A non derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments
 - A derivative that will or may be settled other than by the exchange of a fixed amount of cash, or another financial asset for a fixed number of the entity's own equity instruments



What is a Financial Liability?

Any **contractual** obligation:

- to deliver cash or another financial asset to another entity;
or
- to exchange financial instruments with another entity under conditions that are potentially unfavorable (e.g. a swap with a negative fair value).
- A contract that will or may be settled in the entity's own equity instruments and is:
 - A non derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments
 - A derivative that will or may be settled other than by the exchange of a fixed amount of cash, or another financial asset for a fixed number of the entity's own equity instruments



What is an Equity Instrument?

- Any contract that evidences a **residual interest** in the assets of an enterprise after deducting all of its liabilities.
- Distinguishing financial liabilities and equity instruments can be complex *[this topic will be covered in the Debt versus Equity section]*



Simple Examples

- Cash
- Deposit of cash in financial institution
- Trade accounts receivable and payable
- Notes receivable and payable
- Loans and receivable and payable
- Bonds receivable and payable
- Perpetual debt



Simple Examples

- Inventories
- Property Plant and Equipment
- Leased assets
- Intangible Assets
- Gold bullion
- Prepaid expenses
- Differed revenue and warranty obligations



Examples of Derivative financial instruments

- Convertible debentures
- Forward Contracts
- Interest Rate Swaps
- Currency Swaps
- Call Options
- Put Options

A derivative effectively transfer the risk inherent in an underlying primary instrument between the contracting parties without any need to transfer the underlying instruments themselves

Types of Financial Instrument

Financial Instrument

Primary

- ▶ Deposits of cash
- ▶ Bonds investments, commercial papers
- ▶ Loan receivables
- ▶ Receivables / payables (including finance leases)
- ▶ Deposits, borrowings
- ▶ Equity investments

Derivatives

- ▶ Forwards/futures
- ▶ Financial options
- ▶ Swaps
- ▶ Caps and collars

Combinations

- Convertible debt
- Exchangeable debt
- Dual currency bond
- Equity indexed note

Scope

- All Financial Instruments except those specifically addressed by other standards, such as:
 - Interests in subsidiaries, associates, joint ventures (LKAS 27, LKAS 28, LKAS 31) unless, according to those standards, they should be accounted for under LKAS 39
 - Rights and obligations under leases (LKAS 17)
 - Assets and liabilities under employee benefit plans (LKAS 19)
 - Share-based payments (SLFRS 2)
 - Equity instruments issued by the reporting enterprise
 - Rights and obligations under insurance contracts as defined, or specifically covered, by SLFRS 4
- Yet LKAS 39 may still apply for some of these transactions (e.g., embedded derivatives in insurance contracts, measurement for cash-settled share-based payment arrangements)



Scope Issues: Financial Guarantee Contracts

- A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor defaults
- Depending on the features, financial guarantee contracts are accounted for under LKAS 39 or SLFRS 4



Scope Issues: Loan Commitments

- Firm commitments to provide credit under pre-specified terms and conditions; accounted for under LKAS 37 or 39
- Covered by LKAS 39:
 - Commitments designated as financial liabilities at fair value through profit or loss (*subject to requirements under the Fair Value Option*)
 - Commitments that can be settled net in cash or by delivering or issuing another financial instrument
 - Commitments within the same class where the entity has a past practice of selling the assets resulting from its loan commitments shortly after origination

Scope Issues: Loan Commitments

- Covered by LKAS 39 (continued):
 - Commitments to provide a loan at a below-market interest rate
- LKAS 37 applies for issuers of loan commitments if LKAS 39 does not apply
 - Provision should be established if commitment is an onerous contract

Scope Issues: Equity Instruments

- Issuer's perspective: Equity instruments are generally covered by LKAS 32
 - SLFRS 2 applies with respect to share-based payment arrangements
- Investor's perspective: Investments in subsidiaries, associates and joint ventures that are consolidated, proportionately consolidated or equity accounted in consolidated financial statements are outside the scope of LKAS 39/32 and SLFRS 7
 - Apply LKAS 27: *Consolidated and Separate Financial Statements*, LKAS 28: *Investments in Associates*, or LKAS 31: *Interests in Joint Ventures*



Debt versus Equity

- LKAS 32 provides principles for the distinction between liabilities and equity classification
- An instrument is classified as liability or equity based on the substance of the contractual arrangements rather than its legal form



Remember Definition of a Financial Liability

- Any **contractual** obligation:
 - to deliver cash or another financial asset to another entity; or
 - to exchange financial instruments with another entity under conditions that are potentially unfavorable (e.g. a swap with a negative fair value).



Debt versus Equity

- With this definition of a financial liability:
 - Many preferred shares are treated as liabilities, unless redemption or payment of dividends is at the discretion of the issuer
 - Shares in mutual funds and cooperatives are liabilities, as they can be redeemed at the option of the investors



What is a Financial Liability?

- A contract that **will or may** be settled in the **entity's own equity** instruments and is:
 - a **non-derivative** for which the entity is or may be obliged to deliver a **variable** number of the entity's own equity instruments; or
 - a derivative that will or may be settled **other than** by the exchange of a **fixed amount of cash or another financial asset** for a **fixed number of the entity's own equity instruments**
 - for this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments



Illustration

- Company X issues 1000 units of mandatorily redeemable preference shares (MRPS). There is a fixed redemption period for these shares; holders of these shares can opt to redeem the shares at any time for a fixed amount of cash
- Company Y enters into a contract to purchase oil by issuing a variable amount of its own shares that is equivalent to the market value of 1m barrels of oil
- Company Z issues 100 warrants to company S. Company Z will have to issue 100 units of its own share to company S if the latter exercises the warrant



Financial Liability

- In all of the following cases (1)-(3), the contractual obligation to deliver cash creates a financial liability of the issuer
- The present value of the redemption amount is reclassified from equity and the financial liability is recognised initially under LKAS 39 (LKAS 32.23)

Financial Liability

Critical features in differentiating a financial liability (from an equity instrument)

- 1) Contractual payment obligations (LKAS 32.23; LKAS 32.AG37; LKAS 32.AG27(a))
→ Interest payments, repayment of debt
- 2) Contractual components of a financial instrument that creates a financial liability of the entity and grants e.g. an option to the holder of the instrument to convert it into an equity instrument (LKAS 32.28-32; LKAS 32.23; LKAS 32.AG27(b); LKAS 32.AG37) → convertible bonds
- 3) A financial instrument may require the entity to deliver cash or another financial asset in the event of the occurrence or non-occurrence of uncertain future events that are beyond the control of both the issuer and the holder of the instrument (LKAS 32.25; LKAS 32.AG28) → Contingent settlement provisions beyond the control of the entity

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Financial Liability

E.g.: Contractual components of a financial instrument that creates a financial liability:

Consider the following instrument issued by an entity:

- An issuer is offering LKR 100 principal amount; the present value of the redemption amount is LKR 95; net proceed is LKR 120
- No dividend/interest payments in the first year and discretionary coupon in LKR afterwards
- After the expiration of the first year, the investor has the right to put back LKR 100 or convert the loan into one share of the entity
→ long call option for the investor or
→ short put option for the issuer

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Financial Liability

Example (cont'd): Accounting entries on the date of issuance:

DR	LKR	CR	LKR
Cash	120	Financial liability	95
		Equity	25

- The terms of the conversion option complies with the requirements of an equity instrument under LKAS 32
- Fair value of the financial liability (zero bond) is recognised initially under LKAS 39
- Subsequently, the financial liability is measured at amortised cost using effective interest method in accordance with LKAS 39

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Distinction Between Debt and Equity - Settlement Options

- When a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument

Debt versus Equity

Contracts involving an entity's own equity

Derivative contract	Gross Physical Settlement	Net Settlement (Net Cash or Net Shares)	Issuer/Counterparty Choice of Gross or Net Settlement
Forward to Buy	Liability	Derivative	Liability
Forward to Sell	Equity	Derivative	Derivative
Purchased or written call	Equity	Derivative	Derivative
Written put	Liability	Derivative	Derivative
Total return swap	-	Derivative	-

Debt versus Equity: Compound Instruments

- Where the instrument contains both liability and equity components, they should be classified and accounted for separately. (Requires bifurcating into liability and equity elements)
 - Interest, dividends, losses and gains should be classified in the P&L consistently with the balance sheet treatment
 - For example, a convertible debt instrument will be split into an equity conversion option (an equity instrument) and debt component.
- Fair value of liability is determined first; residual amount of proceed is allocated to equity

Compound instruments

- Can be settled with either fixed amount of cash or fixed number of shares is compound instrument (both debt & equity)
- Required to split components & measure separately

Issue: Foreign currency denominated convertible notes

Fixed amount of
non-functional
currency?



Liability!! Why?
Because considered
variable amount of cash

Compound instruments (cont)

- Debt measured first:
 - Initial recognition measurement: Determine FV of expected cash flows (excluding conversion feature – discounted at rate applicable to instrument without conversion feature)
 - Subsequent measurement: use effective interest rate method
- Equity is residual – not subsequently remeasured
- Transaction costs – allocated to debt & equity on inception
 - Early conversion may result in P&L charge for unamortised transaction costs

Splitting a Compound Financial Instrument

Example: Convertible Debt Instrument

Proceeds from issuance of debt instrument		XX
Less: Present value of the principal	XX	
Present value of the interest	XX	
Total liability component		XX
Equity component		XX

Journal entry (Illustration only):

Dr Cash	1,000	
Cr Convertible debt (host)		850
Cr Equity component of convertible debt		150

From the perspective of the issuer of the convertible debt instrument, the equity component is not considered as a derivative under LKAS 39. From the perspective of the investor, it is an embedded derivative which has to be carried at fair value.

Splitting a Compound Financial Instrument

Example: Convertible Debt Instrument (continued)

Journal entry:

Dr Interest expense	XX	
Cr Convertible debt – host		XX

Assuming no conversion takes place: For accounting purposes, additional interest expense is recognized for the accretion of Day 1 discount (150) over the term of the loan, to gradually increase the carrying amount of the convertible debt to equal its redemption value (1,000) at maturity date.



Contingent Settlement Provision

Contingent settlement provisions (CSPs)

- May issue financial instrument where manner of settlement depends on:
 - Occurrence or non-occurrence of uncertain future event; or
 - Outcome of uncertain circumstances (IAS 32.25)
- Where events beyond control of issuer & holder
 - Issuer does not have unconditional right to avoid settlement so = liability unless:
 - Contingent settlement provision not genuine
 - Requirement to settle only in event of liquidation of issuer



Contingent Settlement Provision

- A financial instrument is a liability if: upon occurrence or non-occurrence of uncertain future events beyond control of the issuer and the holder of the instrument, a financial instrument may require the entity
 - To deliver cash or another financial asset
 - To settle it in such a way that it would be financial liability
- To classify as equity, need the **unconditional right to avoid** delivering cash or another financial asset unless certain criteria are met

LKAS 32.25-1 - Contingent settlement provisions

• Issue : What contingent settlement provisions would be considered *not to be within the control of the issuer* and therefore result in a liability classification in the issuer's financial statements?

Paragraph 25 of LKAS 32

A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of *uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument*. **The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability).** Therefore, it is a financial liability of the issuer.

LKAS 32.25-1 - Contingent settlement provisions (cont'd)

Paragraph 25 of LKAS 32 (cont'd)

- Financial liability of issuer unless:
 - Part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or
 - Issuer can be required to settle the obligation in cash or another financial asset (or otherwise settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

- Paragraph 25 of LKAS 32 lists the following as beyond control of both issuer and holder:
 - Change in a stock market index
 - Change in CPI
 - Interest rate or taxation requirements
 - Issuer's future revenues
 - Net income or debt to equity ratio

Conclusion under LKAS 32.25-1

- The following contingent settlement provisions DO NOT trigger liability classification :
 - Issuer makes a distribution on ordinary shares,
 - Issue subordinated securities in first 12 months that rank equally or in priority to the securities,
 - Issue an IPO prospectus prior to conversion date,
 - Issuer will not dispose of all or substantially all of its business undertaking or assets,
 - Commencement of proceedings for the winding up of the issuer
 - Not under control but liquidation exemption applies

Examples of LKAS 32.25-1 - Contingent settlement provisions (cont'd)



Events NOT under the control of the issuer

- The following CSPs DO trigger liability classification :
 - Upon successful takeover of the issuer
 - Except if the approval of the shareholders as a body is required
 - Event of default under any of the issuer's debt facilities
 - Upon the appointment of a receiver, administrator, entering a scheme of arrangement, or compromise agreement with creditors
 - Except in jurisdictions where the liquidation exemption is met.
 - Upon commencement of proceedings for the winding up of the parent or issuer
 - Change in accounting, taxation, or regulatory regime which is expected to adversely affect the financial position of the issuer.
 - Suspension of listing of the issuer's shares for greater than x days
 - Except in jurisdictions where the reasons for suspension are controlled by the entity.
 - Change in credit rating of the issuer
 - Issue of an IPO prospectus prior to conversion date

Contingent Settlement Provision

CPSs embedded in a convertible bond

- Example:
 - Convertible bonds issued at par with a three year term, interest is payable annually in arrears at a nominal interest amount. Each bond is convertible at any time up to maturity into 250 ordinary shares
 - However the terms allow the holder to demand immediate repayment at face value in certain situations for example:
 - Gearing exceeds a given value; or
 - Interest cover falls below a predetermined value; or
 - Entity is subject to a change of control; or
 - The entity enters formal proceedings to protect it from the claims of creditors that do not amount to liquidation



Contingent Settlement Provision

CPSs embedded in a convertible bond

- Additional features represent a contingent settlement provision, but this instrument would still have a debt and equity component
- How is this reconciled with an instrument which looks and behaves like equity but because of a contingent settlement provision has a liability classification?
- How do you assess contingencies on convertibles?
 - First identify the two components and then attribute terms to the different components
 - Analyse contingent settlement provisions in relation to the entire instrument?



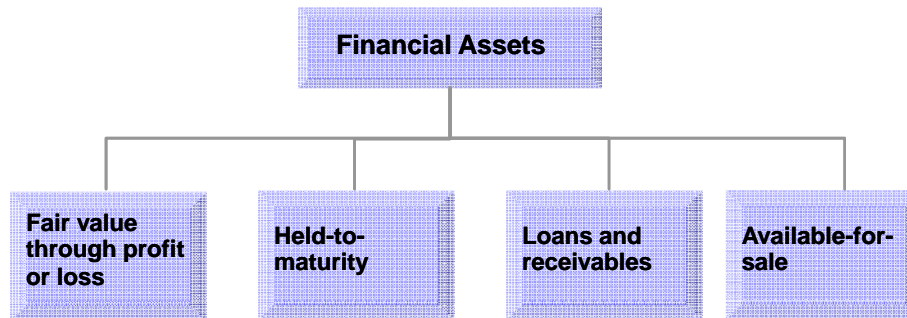
Treasury Shares

- No gain or loss shall be recognized in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments
- Consideration paid or received shall be recognized directly in equity

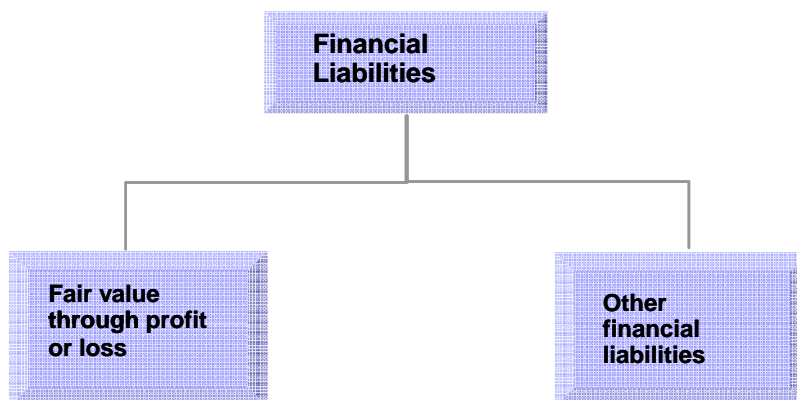
Classification and presentation

- Categories of financial assets
 - At fair value through profit or loss
 - Held-to-maturity
 - Loans and receivables
 - Available-for-sale
- Categories of financial liabilities
 - At fair value through profit or loss
 - Other financial liabilities
- Fair value option

Categories of Financial Assets



Categories of Financial Liabilities





Financial Assets at Fair Value Through Profit or Loss (FVPL)

Consists of:

- Held-for-trading – includes financial assets that are:
 - acquired principally for the purpose of selling or repurchasing it in the near term;
 - part of a portfolio of identified financial instruments managed together for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - derivative (except for financial guarantees or designated effective hedging instruments)
- Designated FVPL (*discussed under the Fair Value Option section*)



Financial Liabilities at FVPL

Consists of:

- ▶ Held-for-trading – includes:
 - ▶ derivative liabilities not accounted for as hedging instruments;
 - ▶ obligations to deliver financial assets borrowed by a short seller;
 - ▶ financial liabilities that are incurred with the intention to repurchase them in the near term; and
 - ▶ financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking
- ▶ Designated FVPL (*discussed under the Fair Value Option section*)



FVPL Issues

- ▶ If a financial liability is used to fund trading activities, does it make the liability held for trading?
- ▶ What is the definition of 'portfolio'?
 - ▶ Not explicitly defined in IAS 39, but should pertain to a group of financial assets or financial liabilities that are managed as part of that group
 - ▶ If portfolio becomes trading:
 - ▶ HFT classification will apply for the new financial instruments in the portfolio; and
 - ▶ Current classification for the 'legacy' instruments to continue



Financial Assets: HTM

- Financial assets with fixed or determinable payments and fixed maturity:
 - which the enterprise has the **positive intent and ability to hold to maturity**
other than
 - those designated as at fair through profit or loss;
 - those designated as available for sale; and
 - those that meet the definition of loans and receivables.



Financial Assets: HTM – Positive Intention

- Positive intention to hold until maturity **not** present in the following:
 - intention to hold the investment is for only an undefined period
 - investor stands ready to sell the financial asset in response to the following situations (does not apply if non-recurring and could not have been reasonably anticipated):
 - changes in market interest rates or risks
 - liquidity needs
 - changes in the availability of and the yield on alternative investments
 - changes in financing sources and terms
 - changes in foreign currency risk
 - The issuer has a right to settle the financial asset at significantly below amortized cost



Financial Assets: HTM – Tainting

- An entity **SHOULD NOT** classify any financial assets as held-to-maturity if:
 - sold, transferred or exercised put option on more than an insignificant amount of held-to-maturity investments before maturity **during the current year or two preceding years**
- OTHER THAN
 - sales close enough to maturity or exercised call date so that interest rate changes did not have significant effect on fair value;
 - sales after the enterprise has already collected substantially all of the financial asset's original principal; or
 - sales due to an isolated event that is beyond the enterprise's control, is non-recurring and could not have been reasonably anticipated.

Financial Assets: Loans and Receivables (L&R)

Assets with fixed or determinable payments that are **not quoted in an active market** (e.g. unquoted loan assets, trade receivables)

other than

- those intended for short term sale or designated as at fair value through profit or loss;
- those designated as available for sale; or
- those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration

Financial Assets: Available-for-Sale (AFS)

- Financial assets that are not:
 - loans and receivables;
 - held-to-maturity investments; or
 - financial assets at fair value through profit or loss
- Includes loans and receivables that are designated as AFS



Financial Liabilities: Other Liabilities

- ▶ Non- trading liabilities
- ▶ Financial liabilities not designated as at fair value through profit or loss



Fair Value Option

- An entity's decision to designate is similar to an accounting policy choice
 - although the entity is not required to apply this designation to all similar transactions
- Fair value designation has been applied to a broad spectrum of instruments:
 - Loans
 - Structured assets
 - Structured debt
 - Straight debt (in lieu of fair value hedge accounting)
- But important to note restrictions imposed on designation option



Fair Value Option

- ▶ **Option to designate a financial instrument that is not held for trading as a financial asset or financial liability at fair value through profit or loss only if :**
 - ▶ it significantly reduces an accounting mismatch;
 - ▶ is part of a group of financial instruments that is managed and whose performance is evaluated on a FV basis; or
 - ▶ contains an embedded derivative, unless the derivative does not significantly modify cash flows or it is clear that it is closely related



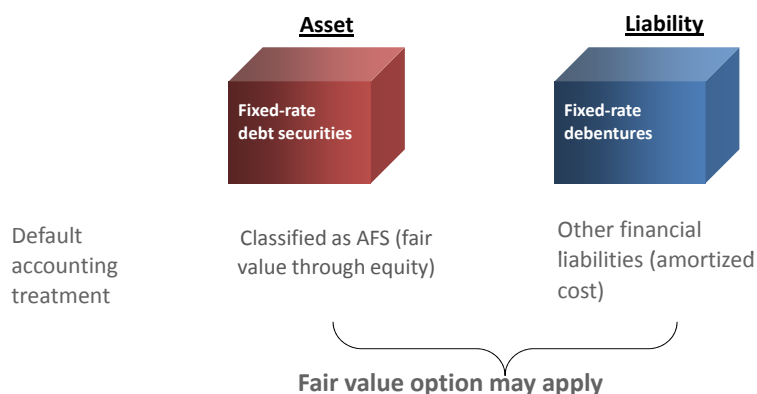
Reduction of an Accounting Mismatch

Examples:

- ▶ **Bank has liabilities whose cash flows are contractually based on performance of assets that otherwise would be classified as AFS**
- ▶ **Bank has financial assets, financial liabilities or both that:**
 - ▶ share a risk that gives rise to opposite changes in fair value that tend to offset each other; and
 - ▶ only some of the instruments are carried as at FVPL (e.g., derivatives)
- ▶ **Bank has financial instruments that fail the requirements of hedge accounting (e.g., hedge effectiveness testing not met)**

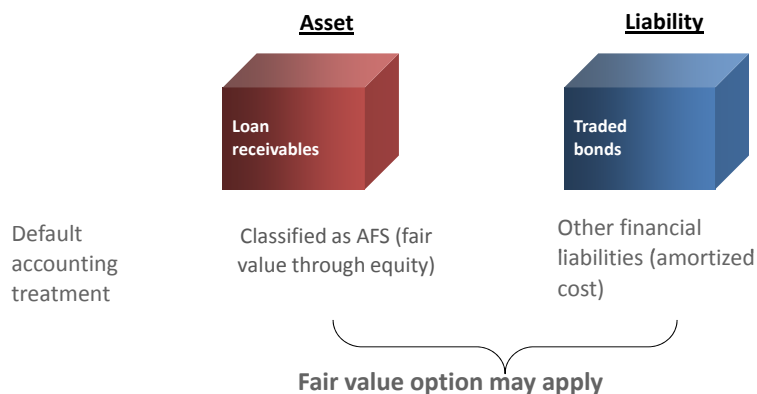
Reduction of an Accounting Mismatch

Portfolio of fixed-rate assets financed by fixed-rate liabilities;
fair value changes tend to offset each other



Reduction of an Accounting Mismatch

Group of loan receivables financed by Bank's issuance of traded bonds; fair value changes tend to offset each other





Group of Financial Instruments Managed Together

- ▶ Applies if group of financial assets, financial liabilities or both is managed and performance is evaluated on a fair value basis
- ▶ Operational requirements
 - ▶ Documented risk management or investment strategy
 - ▶ Information on fair value about the group is provided to key management personnel
- ▶ Bank's documented asset-liability management (ALM) policies and strategies are thus critical



Group of Financial Instruments Managed Together

Examples:

- ▶ Entity has financial instruments that share one or more risks and those risks are managed and evaluated on a fair value basis based on a documented ALM policy
- ▶ Bank issued a structured product containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments
- ▶ Bank originates fixed-rate loans and manages the benchmark interest rate risk using a mix of derivative and non-derivative financial instruments
- ▶ Entity is a venture capital organization, mutual fund, unit trust or similar entity with a total return profit objective



- ▶ Designation can apply unless:
 - ▶ embedded derivative(s) does not significantly modify the contract's cash flows; or
 - ▶ with little or no analysis, it is clear that separation is prohibited based on an evaluation of a similar hybrid instrument.



Measurement



- Initial measurement
 - Transaction costs
 - Bid-ask spread
- Subsequent measurement
 - Fair value versus cost/amortized cost
 - Treatment of unquoted equity instruments and related derivatives
 - Demand deposits and similar liabilities
- Fair value measurement principles:
 - Quoted prices in an active market
 - Use of valuation techniques for inactive markets

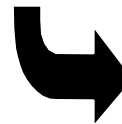
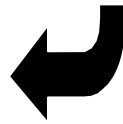


- Recognize a financial asset or a financial liability on the balance sheet when the entity becomes a **party to the contractual provisions** of the instrument
- Measure and record financial instruments at **fair value** on initial recognition

Initial Measurement Principle

Financial asset or financial liability is initially recognized at fair value

fair value of consideration given in case of asset



fair value of consideration received in case of liability

Initial Measurement: Transaction Costs

- Defined as incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument
- Except for financial assets/liabilities at fair value through profit or loss, fair value includes transaction costs that are directly attributable to the acquisition or issue of the financial asset or liability
- Examples of transaction costs
 - Fees and commissions paid to agents, advisers, brokers, and dealers
 - Levies by regulatory agencies
 - Transfer taxes and duties

Initial Measurement: Transaction Costs

- **Not** transaction costs:
 - Debt premiums or discounts
 - Financing costs
 - Allocations of internal administrative or holding costs
- What about internal costs?
 - Treat as transaction costs only if **incremental and directly attributable** to the financial instrument (example is commissions paid to sales staff with respect to a sold financial instrument) – this would be rare

Initial Measurement: Transaction Costs

Illustration

- The Bank acquires an equity security that will be classified as available-for-sale. The security has a fair value of 100 and this is the amount A is required to pay. In addition, A also pays a purchase commission of 2. If the asset was to be sold, a sales commission of 3 would be payable.

What is the initial measurement of the asset?

Initial Measurement: Bid-Ask Spread

- ▶ Differential between the 'bid' and the 'asking' (or offer) price
- ▶ IAS 39 views this spread as including only transaction costs and not other adjustments (e.g., fair value adjustment for counterparty credit risk)

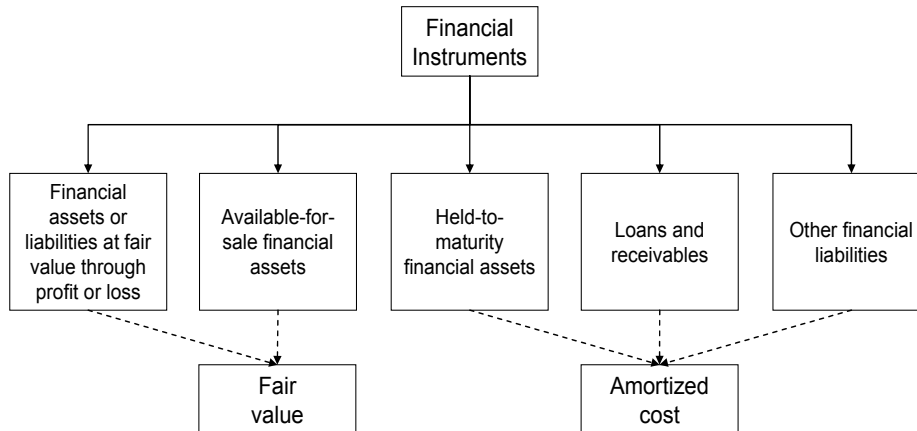
Initial Measurement: Bid-Ask Spread

Illustration

- ▶ The Bank acquires an equity security to be classified as available-for-sale. The Bank purchases the asset in an active market where no explicit transaction costs are charged, but separate bid and offer prices are quoted.

On purchase date, the security has an asking price of 102 (the amount that the Bank is required to pay) and a bid price of 97 (the amount that the Bank would receive if it sells the asset). How should this asset be initially measured in the books?

Subsequent Measurement



Subsequent Measurement: HTM and L&R

Measured at amortized cost using **effective interest method**

Initial value - Principal repayments + Cumulative amortization/accrual - Write-down for impairment or uncollectibility

Gain/loss from amortization is recognized in P&L



Effective Interest Method

- **Effective interest method** – method of calculating the amortized cost of a financial instrument (or group of instruments) and of allocating the interest income or expense over the relevant period
- **Effective interest rate** – rate that exactly discounts estimated future cash payments or receipts over the expected life of the instrument or, when appropriate, a shorter period, to the instrument's net carrying amount
 - Includes integral fees and points paid or received, transaction costs, premiums or discounts
 - Excludes the effect of future credit losses



Illustration: Application of the Effective Interest Method and Revision of Estimates

- At the end of 2007, the Bank purchased a debt instrument with 5 years remaining to maturity for its fair value of LKR1,000. The instrument has a principal amount of LKR1,250 and carries fixed interest of 4.7% payable *annually* ($LKR1,250 \times 4.7\% = LKR59$ per year); effective interest is 10%
- The contract also specifies that the issuer has an option to prepay the instrument and that no penalty will be charged for prepayment.
- At inception, there is an expectation that the borrower will not prepay.

Illustration: Application of the Effective Interest Method and Revision of Estimates

- The table below provides information on the amortized cost, interest income and cash flows of the debt instrument for each period based on the terms provided.

YEAR	Carrying amount at the start of year	Interest income	Cash Flows	Amortization	Amortized cost at the end of year
2008	1,000.00	100.00	59.00	41.00	1,041.00
2009	1,041.00	104.00	59.00	45.00	1,086.00
2010	1,086.00	109.00	59.00	50.00	1,136.00
2011	1,136.00	113.00	59.00	54.00	1,190.00
2012	1,190.00	119.00	59.00	60.00	1,250.00

- On the first day of 2010 the investor revised its estimates. It now expects that 50% of the principal will be prepaid at the end of 2010 and the remaining 50% at the end of 2012.

Illustration: Application of the Effective Interest Method and Revision of Estimates

- Due to the revision of estimate, the opening balance of the debt instrument in 2010 is adjusted to an amount calculated by discounting the amounts expected to be received in 2010 and subsequent years using the original effective interest rate (10%).

Year	Cash Flows	PV Factor	Present Value
2010	684	0.90909	621.82
2011	30	0.82645	24.79
2012	655	0.75131	492.11
Total Present Value			1,138.72

- This results in the new opening balance in 2010 of P1,138. The adjustment of LKR52 (LKR1,138 – LKR1,086) is recorded in profit or loss in 2010.

Illustration: Application of the Effective Interest Method and Revision of Estimates

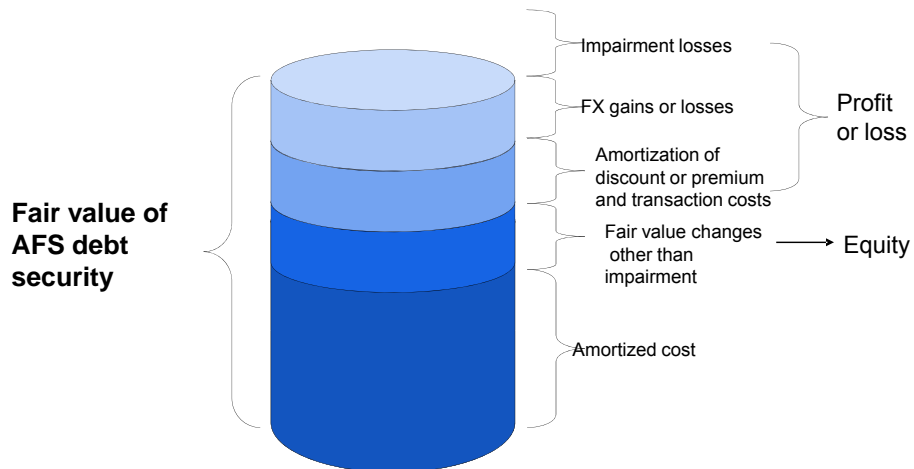
- The table below provides information about the amortized cost, interest income and cash flows as they would be adjusted taking into account this change in estimate:

YEAR	Amortized Cost at the start of year	Interest income	Cash Flows	Amortized cost at the end of year
2008	1,000	100	59	1,041
2009	1,041	104	59	1,086
2010	1,086	114+52	59+625	568
2011	568	57	30	595
2012	595	60	625+30	

Subsequent Measurement: AFS

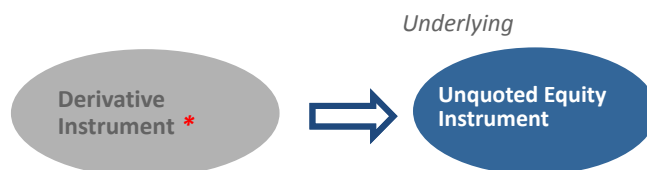
- Measured at fair value with gains/losses from fair value changes recognized directly in equity except for:
 - impairment losses
- ▶ Interest on an AFS asset must be recorded at the effective yield (including amortization of any premium or discount and transaction costs)
 - ▶ The gain or loss taken to equity will only be the extent to which the fair value is greater or less than the asset's amortized cost

Illustration: Accounting for AFS Debt Security



Measurement of Unquoted Equity Securities and Related Derivatives

- ▶ Where equity instruments are not quoted in an active market
 - ▶ measured at cost, subject to impairment, if the fair value cannot be reliably measured
 - ▶ for equity-derivatives, cost measurement will only apply if the derivatives are linked to, and must be settled by delivery of, the unquoted underlying equity instruments



* Must be settled by delivery of unquoted equity instrument



Measurement of Unquoted Equity Securities and Related Derivatives

- Fair value is reliably measurable if:
 - variability in range of reasonable fair value estimates is not significant; or
 - the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value
- Message – cost measurement is not automatically applied for unquoted equity instruments



Demand Deposits and Similar Liabilities

- ‘Core deposits’ that can be reasonably predicted to remain outstanding for a long time
 - As they carry zero or lower than market rates, shouldn’t the fair value of these deposits be calculated and the difference recognized as gain?
- The value to the bank of a depositor choosing not to demand repayment at the earliest opportunity reflects the depositor’s ‘economically irrational’ behavior
 - This value is ignored when measuring the financial liability
 - May be recognized as an intangible asset only in certain circumstances
- Fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid



Financial Instruments: Measurement

Classification	Instrument	Balance Sheet	Fair value gains and losses	Interest and dividends	Impairment	Reversal of impairment	Foreign exchange
At fair value through P&L/held for trading	Debt, equity or derivatives	Fair value	Profit or loss	Profit or loss	--	--	Profit or loss
	Hybrid instrument where embedded equity derivative cannot be bifurcated	Cost	--	Profit or loss	Profit or loss (assets)	Cannot be reversed	--
Held-to-maturity	Debt	Amortized cost	--	Profit or loss: effective interest rate	Profit or loss	Recognized in profit loss	Profit or loss
Loans and receivables	Debt	Amortized cost	--	Profit or loss: effective interest rate	Profit or loss	Recognized in profit or loss	Profit or loss
Available-for-sale financial assets	Debt	Fair value	Equity	Profit or loss: effective interest rate	Profit or loss	Recognized in profit or loss	Profit or loss
	Equity	Fair value	Equity	Profit or loss	Profit or loss	Cannot be reversed through profit or loss	Equity
	Equity, not reliably measurable	Cost	--	Profit or loss	Profit or loss	Cannot be reversed	--
Other liabilities	Debt	Amortized cost	--	Profit or loss: effective interest rate	--	--	Profit or loss



Financial Instruments

Measurement - FV



Fair Value

- “The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arms length transaction.”
- Assumptions in the definition of fair value:
 - Entity is a going concern without the intention or need to liquidate, curtail materially the scale of its operation, or undertake a transaction on adverse terms
 - Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale



Quoted Prices in an Active Market

Why quoted prices are the best evidence of fair value:

- ▶ In an active market, the best evidence of fair value is the quoted price, given that fair value is defined in terms of a price agreed by a knowledgeable, willing buyer and a knowledgeable, willing seller;
- ▶ Results in consistent measurement across entities; and
- ▶ Fair value as defined does not depend on entity-specific factors.

Quoted Prices in an Active Market

- ▶ When determining an instrument's fair value, IAS 39 broadly distinguishes **between those with quoted prices in an active market and all others**
 - ▶ Distinction could matter when recognizing an immediate gain or loss on initial recognition
- ▶ A financial instrument is regarded as quoted in an active market if quoted prices:
 - ▶ are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and
 - ▶ those prices represent actual and regularly occurring market transactions on an arm's length basis

Quoted Prices in an Active Market

Use of bid-ask price for financial instruments with quoted prices:

- | | | |
|---|---|---------------------|
| ▶ For assets held or liability to be issued | ➡ | Bid Price |
| ▶ For assets to be acquired or liability held | ➡ | Asking Price |

When to use mid-market prices?

- | | | |
|---|---|---------------------------|
| ▶ When an entity has assets and liabilities with offsetting market risk | ➡ | Mid- market Prices |
|---|---|---------------------------|



Quoted Prices in an Active Market

- ▶ Where banks operate in different markets and where prices differ
 - ▶ Objective of fair value determination – arrive at the price at which a transaction in a particular instrument would occur in the most advantageous active market to which the entity has immediate access
 - ▶ Price in the more advantageous market should be adjusted to reflect any differences in counterparty credit risk (CCR)
 - ▶ CCR arose from the difference between instruments actually traded in the more advantageous market and those being valued



Quoted Prices in an Active Market

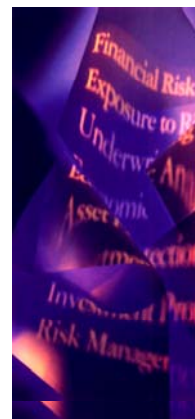
- ▶ Component pricing approach – if quoted prices do not exist for an instrument in its entirety, but active markets exist for the component parts
 - ▶ Example is a bond investment with an embedded derivative linked to a stock market, where active markets exist for similar bond investments and similar equity derivatives (but none for the combined instrument)
- ▶ When current prices are unavailable, use the most recent transaction price
 - ▶ This assumes no subsequent change in economic circumstances

Use of Valuation Techniques

- At initial recognition, the best evidence of fair value is the transaction price unless fair value is evidenced:
 - by comparison with other observable current market transactions in the same instrument (without modification or repackaging), or
 - based on a valuation technique whose variables include only data from observable markets.
- This issue is critical for banks that trade in financial instruments – it precludes the immediate recognition of a profit (e.g., trader's profit) on initial recognition of most financial instruments that are not quoted in an active market

Use of Valuation Techniques – Inputs

- Interest at the basic or risk-free rate (time value)
- Credit risk
- Foreign currency exchange prices
- Commodity prices
- Equity prices
- Volatility
- Prepayment risk and surrender risk
- Servicing costs for a financial asset or a financial liability



Initial Recognition

- Initial recognition
- Regular-way accounting:
 - Trade date versus settlement date accounting
- 'Day 1' Difference issues
 - Receivables
 - Intercompany advances
 - Other transactions
- Overview on 'Day 1' Profits



Initial recognition

- Financial assets or financial liabilities are recognized on the balance sheet when the enterprise becomes a party to contractual provisions of the instrument.
- IAS 39 generally requires entities to use Trade Date accounting. Trade Date is the date an entity commits to buy or sell an asset.
- Exception to the rule:
 - “Regular Way Trades” – allows both trade date and settlement date accounting
 - Use consistently for each category
 - Even if settlement date is used, must still account for the fair value movements in AFS and FVPL assets of which the Bank will take delivery



“Regular Way” Transactions

- Regular way or sale – the purchase or sale of financial assets that requires delivery of the assets within the time frame generally established by regulation or convention in the market place concerned
- The fixed price commitment between trade date and settlement date meets the definition of a derivative (it is a forward contract)
 - In view of the short duration of the derivative contract, “regular way” contracts are specifically exempted from IAS 39
- A “regular way” purchase or sale of financial assets should therefore be recognized using either trade date accounting or settlement date accounting, with consistent application for each category of financial assets

Trade Date/Settlement Date Example

- On December 29, 2006, Bank commits to purchase a financial asset for 10,000 (which is its FV on commitment date)
- The fair values on December 31, 2006 (year-end) and on January 4, 2007 (settlement date) are 9,990 and 10,005, respectively

Trade Date Accounting

	Assets Carried at Amortized Cost	Remeasured to Fair value with Changes in Equity	Assets Remeasured to Fair Value with Changes in Profit or Loss
Balances			
29 December 2006			
Financial asset	10,000	10,000	10,000
Liability	(10,000)	(10,000)	(10,000)
31 December 2006	-	-	-
Receivable			
Financial asset	10,000	9,990	9,990
Liability	(10,000)	(10,000)	(10,000)
Equity	-	10	
P&L	-		10
4 January 2007		-	-
Receivable			
Financial asset	10,000	10,005	10,005
Liability	-	(5)	-
Equity	-		-
P&L			(5)

Settlement Date Accounting

	Assets Carried at Amortized Cost	Assets Remeasured to Fair value with Changes in Equity	Assets Remeasured to Fair Value with Changes in Profit or Loss
Balances			
29 December 2006			
Financial asset	-	-	-
Liability	-	-	-
31 December 2006			
Receivable	-	-	-
Financial asset	-	-	-
Liability		(10)	(10)
Equity	-	10	-
P&L	-	-	10
4 January 2007			
Receivable	-	-	-
Financial asset	10,000	1 0,005	10,005
Liability	-	-	-
Equity	-	(5)	-
P&L	-	-	(5)

Trade Date Accounting

- Trade date – date on which an entity commits itself to purchase or sell an asset; trade date accounting requires:

Assets to be bought

- the recognition of an asset to be received and the recognition of a liability to pay for it; or

Assets to be sold

- the derecognition of an asset to be sold along with the receivable from the buyer for payment.



Settlement Date Accounting

- Settlement date – date that an asset is delivered to or by an entity; settlement date accounting requires the following:

Assets to be bought

- assets are recognized on the date received by the entity; any change in the fair value of the asset to be received is accounted for as follows:
 - Assets carried at cost or amortized cost= the change in value is not recognized
 - FVPL = change in value is recognized in profit or loss
 - AFS = change in value is recognized in equity

Assets to be sold

- derecognition of the asset, recognition of any gain or loss on disposal, and the recognition of a receivable from the buyer for payment is recorded on the day delivered
- A change in the fair value of the asset between trade date and settlement date is **not recorded** in the financial statements, even if the entity applies settlement date accounting, because the seller's right to changes in the fair value ceases on the trade date



Initial recognition – Day 1 Difference Issues

- Bank grants a 5-year LKR100 million non-interest bearing receivable to Company X.
- Assume that the present value of the receivable using a market rate of 12% is LKR57 million.
- What is the proper accounting treatment of the “Day 1 difference” of LKR43 million?

Answer depends on substance and facts
of transaction



Initial recognition – Day 1 Difference Issues

- If substance is a '**concession lending**' between unrelated parties, Day 1 difference will be treated immediately as a loss
- Interest income will be subsequently recognized using the accretion process

Initial Recognition

Dr. Loans receivable	57M	
Dr. Expense	43M	
Cr. Cash		100M

Subsequent Entry

Dr. Loans receivable	xx	
Cr. Interest income		xx



Initial recognition – Day 1 Difference Issues

Lending by a Parent to the Subsidiary

- If the transaction is between a Parent and its Subsidiary, capital and investment accounts may be affected
- Interest income will be subsequently recognized using the accretion process

Parent's Books

Initial Recognition

Dr. Loans receivable	57M	
Dr. Investment	43M	
Cr. Cash		100M

Subsequent Entry

Dr. Loans receivable	xx	
Cr. Interest income		xx

Initial recognition – Day 1 Difference Issues

Lending by a Parent to the Subsidiary (continued)

Subsidiary's Books

Initial Recognition

Dr. Cash	100M	
Cr. Investment		57M
Cr. Equity		43M

Subsequent Entry

Dr. Interest expense	xx	
Cr. Advances from Parent		xx

Initial recognition – Day 1 Difference Issues

- What are the accounting implications if:
 - Subsidiary is the lender?
 - Lending is between affiliates with 'common control'

Initial recognition – Day 1 Difference Issues

Bank grants a 5-year LKR10 million non-interest bearing receivable to Employee Z. Assume that the present value of the receivable using a market rate of 12% is LKR 5.7 million.

What is the proper accounting treatment of the “Day 1 difference” of LKR 4.3 million?

Day 1 difference will be treated as prepaid compensation that will be subsequently amortized through profit or loss along with the accretion of interest on the receivable

Initial recognition – Day 1 Difference Issues

Initial Recognition

Dr. Advances to Employees	5.7M	
Dr. Prepaid Compensation	4.3M	
Cr. Cash		10M

Subsequent Entry

Dr. Advances to Employees	xx	
Cr. Interest Income		xx*

Dr. Salary Expense	xx*	
Cr. Prepaid Compensation		xx

To record the accretion of interest income

* Same amount of amortization, based on EIR

Initial recognition – Day 1 Difference Issues

Bank originated a 5-year LKR10 million non-interest bearing sales contract receivable to Company Z. Assume that the present value of the receivable using a market rate of 12% is LKR 5.7 million. Per Bank's records, the sales price is LKR10 million while the cost of the property is LKR 6 million (resulting in a gain of LKR 4 million).

What is the proper accounting treatment of the "Day 1 difference" of LKR 4.3 million?

Initial recognition – Day 1 Difference Issues

Initial Recognition

Dr. Receivables	10M	
Dr. Loss on Sale	.3M	
Cr. Equipment		6.0M
Cr. Deferred Interest Income		4.3M*

* *Deferred interest income is offset against receivables for balance sheet purposes*

Subsequent Entry

Dr. Deferred Interest Income	xx	
Cr. Interest Income		xx

To record the accretion of interest income

Initial recognition – Day 1 Difference Issues

Bank leases a property of Company X for two (2) years to be used as bank premise. This was accounted for as an operating lease. Bank is required to pay a refundable security deposit of LKR100,000 to Company X at the inception of the lease for which no interest is received. Since the security deposit is non-interest bearing, the market rate of interest for a similar two-year loan with a payment of interest at maturity is 11% for 24 months plus a credit spread of 300 basis points.

What is the proper accounting treatment of the “Day 1 difference” of LKR 23,710?

Day 1 difference shall be recorded by the lessee as prepaid rent and by the lessor as deferred rent

Initial recognition – Day 1 Difference Issues

Lessee's Books

Initial Recognition

Dr. Operating Lease Deposit	76,290	
Dr. Prepaid Rent	23,710	
Cr. Cash		100,000

Subsequent Entry

Dr. Operating Lease Deposit	xx	
Cr. Interest Income		xx*

To record the accretion of security deposit

Dr. Rent Expense	xx*	
Cr. Prepaid Rent		xx

To record the amortization of prepaid rent

* Amounts shall not be the same since the accretion of security deposit is based on the EIR method while the amortization of prepaid rent is based on straight-line basis

Initial recognition – Day 1 Difference Issues

Lessor's Books

Initial Recognition

Dr. Cash	100,000	
Cr. Operating Lease Deposit – Payable	76,290	
Cr. Deferred Rent	23,710	

Subsequent Entry

Dr. Interest Expense	xx	
Cr. Operating Lease Deposit – Payable	xx*	

To record the accretion of security deposit

Dr. Deferred Rent	xx*	
Cr. Rent Income	xx	

To record the amortization of deferred rent

* Amounts shall not be the same since the accretion of security deposit is based on the EIR method while the amortization of deferred rent is based on straight-line basis

Overview on 'Day 1' Profits

- ▶ Represents the margin that has been 'locked in' as a result of the differential between the price charged to a customer and prices available to the dealer in wholesale markets
- ▶ The dealer has a wholesale position in the dealer market; the end user has a retail position in the retail market. The dealer operates across both markets, which means that it can earn:
 - ▶ Wholesale profit – dealer can trade at a slightly lower spread in the inter-dealer market, generating a profit on all transactions executed with end users
 - ▶ Origination profit – an element of profit to represent the expertise, research and tailoring of the transaction to the client's needs



Overview on 'Day 1' Profits

- Day 1 profit recognized – example is when an instrument is quoted in an active market and the dealer has access to another, more favorable, active market in (virtually) the same instrument
 - the instrument's initial fair value is determined by reference to the more advantageous market (appropriately adjusted for any differences between the instruments, e.g. in credit risk)
- Day 1 profit recognized – another example is in the case of instruments that are not quoted in an active market, and where the initial fair value is determined by reference to a valuation technique
 - Condition for profit to be recognized: all inputs to valuation include data from observable markets

Derecognition



Derecognition: Financial Assets

Derecognize only when:

- ▶ The contractual rights to the cash flows from the financial asset expire; or
- ▶ The entity transfers the financial asset
 - ▶ transfers the contractual rights to receive the cash flows of the financial asset; or
 - ▶ retains the contractual rights but assumes contractual obligation to pay the cash flows to one or more recipients



Derecognition Overview of issues

- Who is the **entity** (consolidation of SPE)?
- Has there been a **transfer** (transfer or pass-through of cash flows)?
- Does the transfer **qualify for derecognition** (transfer or retention of risks and rewards)?
- What is the entity's **continuing involvement**?

“The Board recognizes that many securitizations may fail to qualify for derecognition . . .”

CONSOLIDATE SPE?

PART OR ALL?

Flow Chart – Steps

- ▶ Setting the frame
 - ▶ Who is the entity?
 - ▶ What is the transferred asset?
- ▶ Transfer or pass-through of cash flows
 - ▶ Have the contractual rights expired?
 - ▶ Is there a transfer of rights to receive payments?
 - ▶ Is there a qualifying pass-through of cash flows?
- ▶ Risks and rewards
 - ▶ Has the entity transferred substantially all risks and rewards?
 - ▶ Has the entity retained substantially all risks and rewards?
- ▶ Control and continuing involvement
 - ▶ Has entity retained control of assets?
 - ▶ What is the continuing involvement?

CONSOLIDATE SPE?

PART OR ALL?

Setting the Frame – Who is the Entity?

- The **entity** is the **consolidated group**
- The consolidated group is determined by applying LKAS 27 and SIC 12
- Summary of consolidation principles:
 - Ownership or practical control (LKAS 27);
 - Decision-making or auto-pilot mechanism (SIC 12); and
 - Majority of risks or benefits (SIC 12)
- SIC 12 will normally require the transferor in a securitization to consolidate a transaction-specific SPE
- The derecognition flow chart must be applied from the perspective of the consolidated group



The Consolidated Group – LKAS 27

- ▶ LKAS 27 provides that the consolidated financial statements of an enterprise should include all entities that the enterprise controls
- ▶ Control is presumed to exist if an enterprise owns more than half of the voting power of another entity
- ▶ Control may also exist if an enterprise has:
 - ▶ more than half of the voting power of another entity pursuant to an agreement;
 - ▶ the power to govern the financial and operating policies of another entity; or
 - ▶ the ability to appoint, remove or otherwise control another entity's board of directors.



The Consolidated Group – SIC 12

- ▶ An SPE is an entity created to accomplish a narrow and well-defined objective
 - ▶ This includes securitizing financial assets
- ▶ SIC 12 provides that the following factors may indicate that an enterprise controls an SPE:
 - ▶ In substance, the activities of the SPE are conducted on behalf of the enterprise according to its specific business needs so that the enterprise obtains benefits from the SPE's operations
 - ▶ providing finance to support the needs of the transferor
 - ▶ In substance, the enterprise has decision-making powers (or by an auto-pilot mechanism has delegated those powers) that enable it to obtain a majority of the benefits of the activities of the SPE
 - ▶ power to replace the asset manager if it does not perform
 - ▶ power to veto decisions of the SPE

The Consolidated Group – SIC 12 (cont'd)

- ▶ In substance, the enterprise has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE
 - ▶ consider risks and benefits of each tranche of securities and of any other participants
 - ▶ distinguish equity-like risks and benefits from lender's rate of return and market fees for services
- ▶ In substance, the enterprise retains a majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.
 - ▶ consider all the risks and benefits of the vehicle (e.g. interest rate/credit risk)

Working presumption: Someone should consolidate SPE

CONSOLIDATE SPE?

PART OR ALL?

Setting the Frame – What is the Transferred Asset?

- Apply derecognition principles to **part of financial asset** (or group of similar financial assets) if, and only if:
 - specifically identified cash flows;
 - fully proportionate share of all cash flows; or
 - fully proportionate share of specifically identified cash flows
 - Examples:
 - Interest rate strip (all interest cash flows)
 - Loan participations
- Apply to **entire financial asset** (or group of similar financial assets) in all other cases
 - Examples:
 - First/last 90 percent of collections
 - Fixed percentage of all collections, with guarantee of fixed percentage of principal amount

CONSOLIDATE SPE?

PART OR ALL?

Derecognition in General

- An entity shall **derecognize** a financial asset when, and only when:
 - (a) the contractual rights to the cash flows from the financial asset **expire**; or
 - (b) the entity **transfers** the financial asset and the transfer **qualifies for derecognition**
- Two elements:
 - has there been a “transfer” of the financial asset (pass-through arrangements)?
 - does the transfer “qualify for derecognition” (risks and rewards/control)?

CONSOLIDATE SPE?

PART OR ALL?

Has There Been a Transfer?

- An entity transfers a financial asset if and only if, it either:
 - (a) **transfers** the contractual right to **receive** the cash flows; or
 - (b) **retains** the contractual right to **receive** the cash flows of the financial asset, but enters into a **qualifying pass-through arrangement**.
- What constitutes a transfer of the contractual rights to receive the cash flows?
 - Notice to obligors?
 - Who is physically receiving collections?
 - Is a collection account held by a security trustee an “SPE” under SIC 12?
- Entity is not prohibited from “servicing” financial asset

Pass-Through Arrangements

- The entity is only required to **pay to the extent it collects** equivalent amount from the financial asset
 - Short-term advances by the entity with the **right of full recovery** of the amount lent plus accrued interest at market rates are permitted
- The entity is **prohibited from selling or pledging** the financial asset
- The entity has an obligation to **remit collections without material delay**
 - Reinvesting collections in **cash or cash equivalents** during short period until next payment date is **permitted**, but only if **interest** on such investments is **passed to eventual recipients**
- If any of the three requirements are **not** satisfied, the entity:
 - continues to recognize the financial asset; and
 - recognizes any consideration received as liability.

CONSOLIDATE SPE?

PART OR ALL?

Derecognition? (Risks and Rewards/Control)

- If the entity **transfers substantially all risks and rewards** of ownership of the financial asset, then it shall:
 - derecognize the financial asset; and
 - recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.
- If the entity **retains substantially all risks and rewards** of ownership of the financial asset, then it shall:
 - continue to recognize the financial asset; and
 - recognize any consideration received as liability.
- If the entity has **neither transferred nor retained** substantially all risks and rewards, then ask whether the group has retained **control** of the financial assets.

Derecognition: Financial Assets

- Examples of when an entity has transferred substantially all the risks and rewards of ownership are:
 - an unconditional sale of a financial asset;
 - a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
 - a sale of a financial asset together with a put or call option that is deeply out of the money (i.e. an option that is so far out of the money it is highly unlikely to go into the money before expiry).

Derecognition: Financial Assets

- Examples of when an entity has retained substantially all the risks and rewards of ownership are:
 - a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;
 - a securities lending agreement;
 - a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;
 - a sale of a financial asset together with a deep in-the-money put or call option (i.e. an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and
 - a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.



Control

- Whether the entity has transferred “control” depends on whether the **transferee has the ability to sell the financial assets**
 - Practical ability (rather than contractual right) to sell to third party
 - Market for transferred asset
 - Right to sell financial asset in its entirety, not just investor’s interest
 - Right must be unilateral
 - No additional restrictions
- If the entity **has not retained control** of the financial asset, then it shall:
 - **derecognize** the financial asset; and
 - **recognize separately** as assets or liabilities any rights and obligations created or retained in the transfer.
- If the entity **has retained control** of the financial asset, then it shall:
 - **continue to recognize** asset to the extent of its **continuing involvement**



Impact on Balance Sheet and Profit and Loss

- ▶ Transfers that do not qualify for derecognition:
 - ▶ continue to recognize asset, recognize any consideration received as a liability
 - ▶ recognize any income on the transferred asset and any expense on the financial liability
- ▶ Transfers that qualify for derecognition:
 - ▶ derecognize entire financial asset
 - ▶ recognize separately as financial assets or financial liabilities any rights or obligations retained
 - ▶ recognize in profit and loss difference between carrying amount and consideration received

Impact on Balance Sheet and Profit and Loss

- ▶ Transfers where the entity continues to recognize the assets to extent of its continuing involvement:
 - ▶ extent to which the entity is exposed to changes in value of transferred assets
 - ▶ for a securitization normally this will be the maximum amount of the consideration received that the entity would be required to pay
 - ▶ profit and loss treated the same as in transfers that qualify for derecognition

Illustration: Derecognition

Company A sell to Company B, an unrelated party, an account receivable. The carrying amount of the receivable is \$1,000 and the sell price is \$980

Scenario 1: The sale is with recourse (Company A keep the credit risk related to the account receivable, i.e. if the account is unpaid, Company A will have to compensate Company B)

Answer: In this scenario, the exposure of Company A, before and after the transfer, to the variability and timing of the cash flows, remain the same. Therefore, this transaction does not qualify for derecognition



Illustration: Derecognition

Company A sell to Company B, an unrelated party, an account receivable.
The carrying amount of the receivable is \$1,000 and the sell price is \$980

Scenario 2: The sale is without recourse (Company B will bear all the credit risk related to the account receivable)

Answer: This scenario is the opposite of the first one. The transaction will qualify for derecognition



Illustration: Derecognition

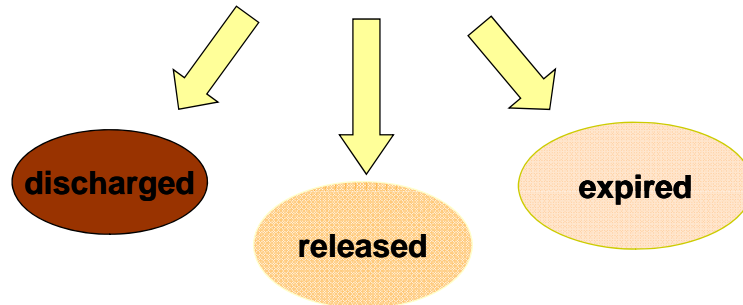
Company A sell to Company B, an unrelated party, an account receivable.
The carrying amount of the receivable is \$1,000 and the sell price is \$980

Scenario 3: Company B is prevented from selling the account receivable to another party without the prior consent of Company A. Company A retains the credit risk related to the account receivable

Answer: The determination of which party has the effective control over the transferred asset is relevant only to the extent that Company A has neither kept nor transferred all the risks and rewards related to the asset. In this case, derecognition is not necessary.

Derecognition: Financial Liabilities

- A financial liability should be removed from the balance sheet when, and only when, it is extinguished



Derecognition: Financial Liabilities

- Liabilities should be derecognized only when the obligation has been discharged, cancelled or expires
 - Payment to creditor cash, goods, services, or other financial asset
 - Legally released from primary responsibility either by process of law or by the creditor
- Economic substance of whether an entity has a liability to a third party is ultimately dictated by the legal rights and obligations that exist between them

Impairment

Topics

- Objective evidence of impairment
- Financial assets carried at amortized cost:
 - Specific assessment
 - Collective assessment
- Interest income after impairment recognition
- Available-for-sale assets
- Reversal of impairment losses



Impairment

- Determination
 - Annual assessment of whether there is **objective evidence** of impairment
 - Test performed for all financial assets except for assets held for trading



What Constitutes 'Objective Evidence'

- Asset-specific loss events include:
 - Significant financial difficulty of the issuer/obligor
 - A breach of contract, such as default or delinquency in interest or principal payments
 - The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider
 - High probability of bankruptcy or other financial reorganization
 - Disappearance of an active market for the financial asset because of financial difficulties



What Constitutes 'Objective Evidence'

- Observable data relevant to portfolio of assets include:
 - Adverse changes in payment status of debtors/ borrowers in the portfolio
 - National or local economic conditions that correlate with defaults on assets in the group
- Objective evidence of impairment for **equity investments** include:
 - Significant changes in technological, market, economic or legal environment indicating that cost of equity investments may not be recovered or
 - Significant prolonged decline in fair value below cost



Discount Rate to Use

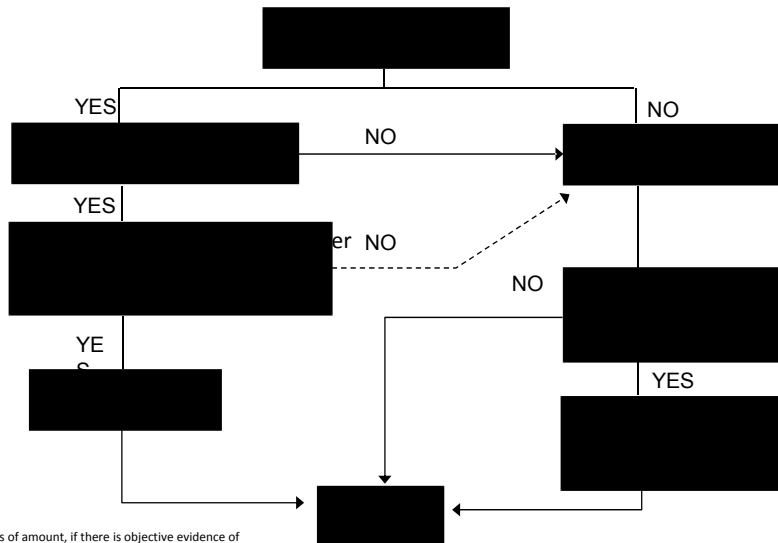
- ▶ Fixed-rate loans
 - ▶ original effective interest rate
- ▶ Floating-rate loans
 - ▶ current effective interest rate determined under the contract
- ▶ Restructured loan
 - ▶ effective interest rate before restructuring

Impairment Assessment

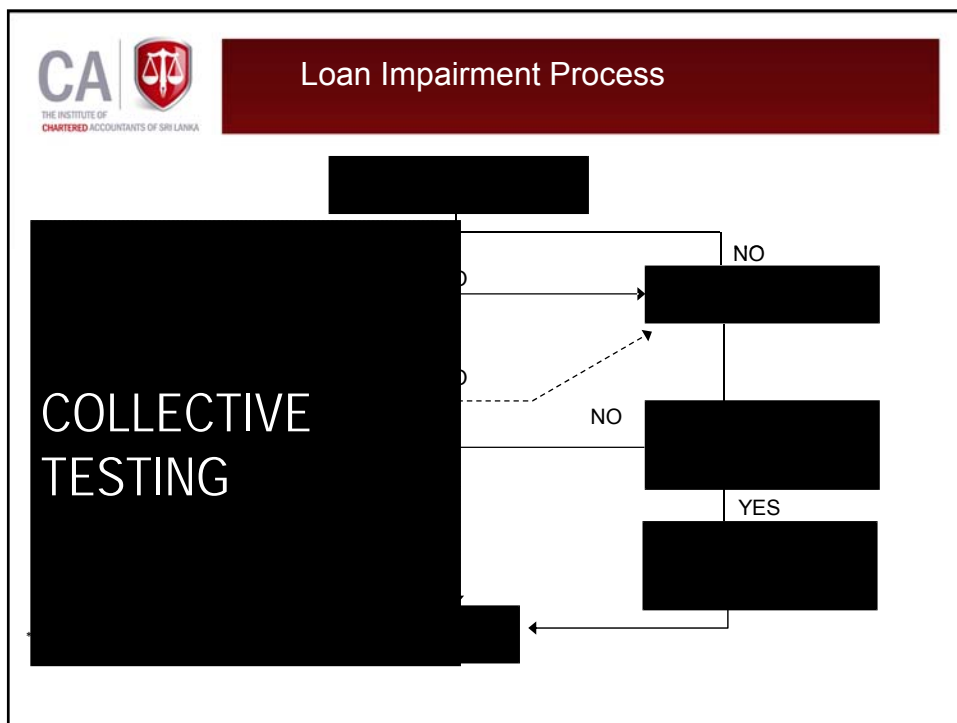
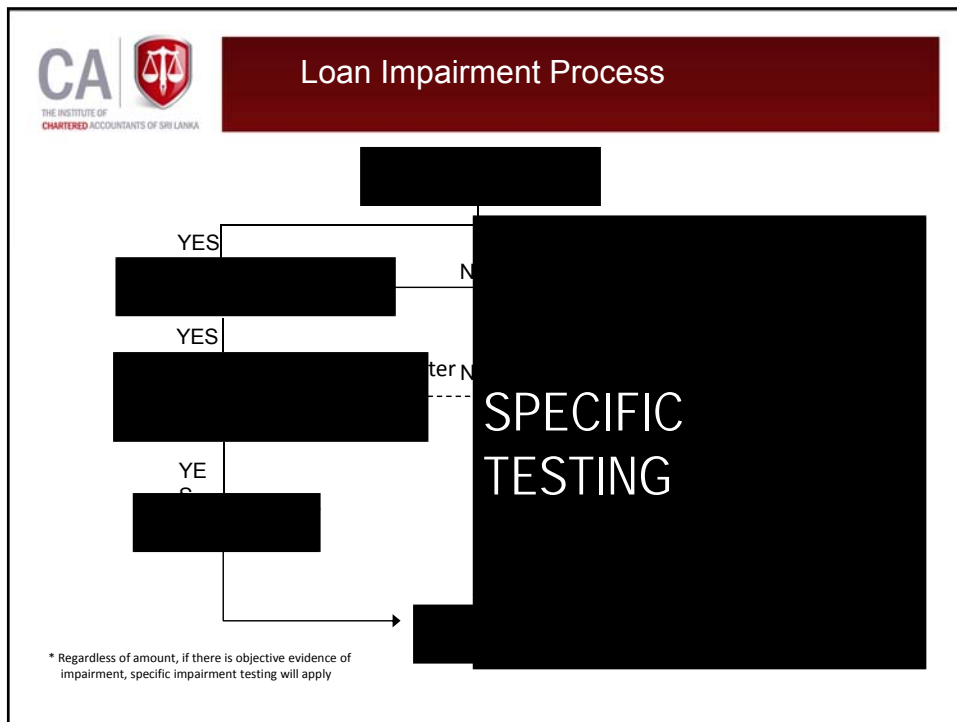
► Levels of impairment assessment:

- Individually significant financial assets are to be assessed individually for impairment
- Individually not significant financial assets are to be assessed collectively for impairment
- Individually not significant financial assets, together with the individually significant financial assets determined not to be impaired, are to be assessed collectively

Loan Impairment Process



* Regardless of amount, if there is objective evidence of impairment, specific impairment testing will apply





Impairment Assessment Process

- Assess periodically whether there is objective evidence that assets may be impaired
 - Standard states 'at each balance sheet date'
 - Incorporate as part of internal loan provisioning review process
- Determine recoverable value of the asset
 - Estimate value and timing of expected future cash flows
 - Perform discounted cash flow analysis using appropriate discount rate
- Determine initial impairment loss
 - Difference between carrying value and present value (PV) of recoverable cash flows
 - Provided either directly or via an allowance account against P&L



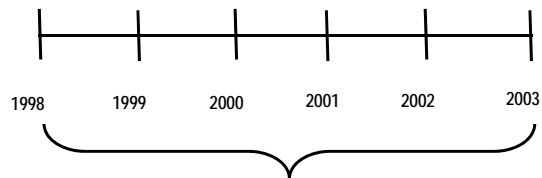
Impairment Assessment Process

- Determine subsequent impairment loss
 - Revise estimates of amount and timing of recoverable cash flows
 - Perform DCF analysis using appropriate discount rate
 - Record reversal of impairment only if change causing reversal can be related objectively to an event occurring after the write-down
 - Accretion of discount recognized as interest income
- Periodic 'back-testing' to reduce difference between loss estimates vs. actual loss experience

Illustration: Restructured Loan Receivable

Original Loan Terms

Original
effective
interest rate
of 15%



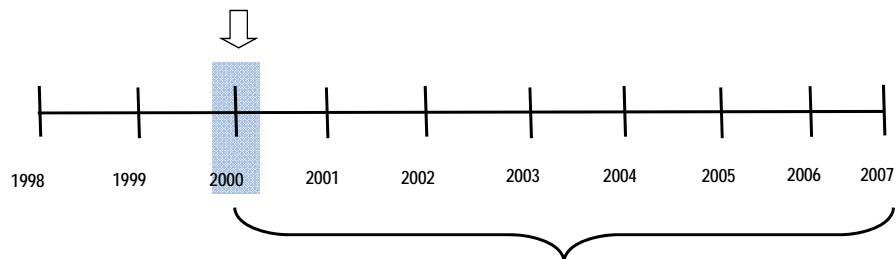
Principal is LKR100 million
Maturity period of 5 years Annual
coupon of 15%

Illustration: Restructured Loan Receivable

Restructured Loan Terms

Loan was restructured due to
borrower's financial difficulties

→ "Objective evidence of
impairment"



Principal is still LKR100 million
New maturity period of 7 years
Revised coupon rate of 5%

Illustration: Restructured Loan Receivable

- ▶ Compute for impairment loss
- ▶ Loan carrying amount versus present value of estimated future cash flows (discounted using the loan's original effective interest rate)

Carrying amount	LKR100 million	
PV of cash flows	58 million	LKAS 39 allows either direct
	-----	reduction or use of an allowance
	LKR 42 million	account
	=====	

Interest Income Post-Impairment

- ▶ Interest income after impairment recognition
 - ▶ AG 93 "... interest income is thereafter recognized using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss."
 - ▶ Interest income for 2001
 - ▶ Coupon received per restructuring agreement is LKR 5 million (computed as LKR100 million x 5%)
 - ▶ Interest income to be recognized under IAS 39 is LKR8.7 million (computed as LKR58 million x 15%)

Collective Impairment

- ▶ Collective assessment includes:
 - ▶ groups of loans with similar risk characteristics that are not individually significant
 - ▶ individually significant loans with no specific objective evidence of impairment
 - ▶ individually significant financial assets assessed to have specific objective evidence of impairment but with no required impairment loss
- ▶ Collective assessment intends to capture losses known to exist in the portfolio but not yet evident ('incurred but not reported' losses)
- ▶ Loss probabilities and other loss statistics differ at a group level between
 - ▶ assets that have been individually evaluated for impairment and found not to be impaired; and,
 - ▶ assets that have not been individually evaluated for impairment

Collective Impairment

Collective assessment should consider the following:

Portfolio factors (relate to information at the portfolio level that suggest adverse changes in the payment status of the borrowers) such as:

- ▶ credit utilization
- ▶ loan to collateral ratios
- ▶ death
- ▶ 'risky borrowers'
- ▶ loan portfolio's age and levels of arrearages

National/local/macro factors (where direct correlation has been established between trends/conditions and the incidence of defaults in a particular grouping) such as:

- ▶ unemployment in a specific geographical location
- ▶ interest rates
- ▶ inflation
- ▶ significant decrease in the price of a commodity that is the revenue source of a borrower
- ▶ significant adverse change affecting borrowers in a group



Collective Impairment – ‘Risk Groupings’

Groupings should be made on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms

Assets may be grouped on the basis of one or more of the following risk characteristics:

- ▶ Estimated default probabilities or credit risk grades
- ▶ Type (for example, mortgage loans or credit card loans)
- ▶ Geographical location
- ▶ Collateral type
- ▶ Counterparty type (for example, consumer, commercial or sovereign)
- ▶ Past-due status
- ▶ Maturity

Potential linkage/convergence with credit grading process



Collective Impairment – Critical Elements

- ▶ Historical loss experience – basis for estimating future cash flows
- ▶ Use peer group data if there is no loss experience (currently not feasible)
- ▶ Adjust historical loss experience based on observable data
- ▶ ‘Directionally-consistent’ concept when relating cash flow estimate changes with changes in underlying observable data
- ▶ Back-testing and calibration of estimation methods
 - ▶ methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.



Collective Impairment – Model/Methodology Considerations

Whether formula-based approaches or statistical methods are used to determine impairment losses in a group of financial assets, any model used should:

- ▶ incorporate the effect of the time value of money
- ▶ consider the cash flows for all of the remaining life of an asset (not only the next year)
- ▶ consider the age of the loans within the portfolio
- ▶ not give rise to an impairment loss on initial recognition of a financial asset



Impairment: AFS Assets Measured at Fair Value

- When a decline in the fair value of an AFS has been recognized in equity and there is objective evidence that the asset is impaired, the cumulative loss in equity should be recycled into profit or loss
- Unquoted equity whose fair value cannot be reliably determined ...
 - when there is objective evidence of impairment, carrying amount is reduced to estimated recoverable amount* – loss to P&L
 - impairment cannot be reversed
- *PV of estimated future cash flows discounted at current market rate of return for a similar asset



Reversal of Impairment Losses- Financial Assets Carried at Amortized Cost

- Previously recognized impairment loss should be reversed, either directly or by adjusting an allowance account.
- Reversals are recognized in the income statement
- Reversal shall not result in a carrying amount that exceeds what the carrying amount would have been had there not been an impairment loss



Reversal of Impairment Losses – AFS Assets Carried at FV

- Reversal of impairment losses
 - For AFS equity investments, impairment cannot be reversed via P&L
 - For AFS debt investments, impairment is reversed when recoverable amount increases and the increase can be objectively related to an event occurring after the loss was recognized

Illustration: Reversal of Impairment Loss on AFS Equity Investment

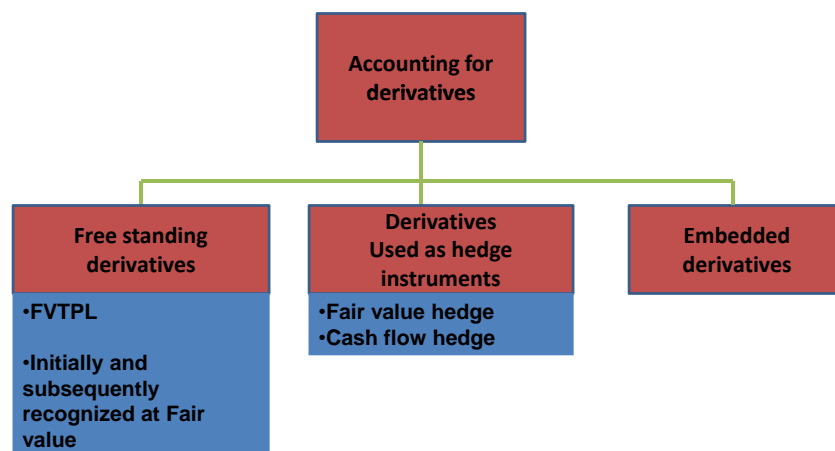
- The Bank acquired 100 shares in Company X on 1 January 2006, for its fair value of LKR 10,000.
- On December 31, 2006 the fair value of available for sale investments was LKR 7,500.
- On December 31, 2007, the Bank's year end, the fair value of the shares in X had fallen to LKR 6,000 and the Bank concluded the shares were impaired.
- On December 31, 2008, the fair value of the shares in X rose to LKR 9,000.

Illustration: Reversal of Impairment Loss on AFS Equity Investment

Account	Debit	Credit
<i>December 31, 2006</i>		
Unrealized gains/ losses	2,500.00	
Available for sale equity investment		2,500.00
To record AFS at its market value		
*(10,000- 7500) The decline is recognized in equity		
<i>December 31, 2007</i>		
Impairment Loss	4,000.00	
Unrealized gains/ losses		2,500.00
Available for sale equity investment		1,500.00
To record AFS at its market value		
*(10,000- 6000) The entire amount of impairment loss is recognized in Profit and loss, any unrealized gains/losses in equity shall be taken to P/L		
<i>December 31, 2008</i>		
Available for sale equity investment	3,000.00	
Unrealized gains/ losses		3,000.00
To record AFS at its market value		
*(9000-6000) The increase shall be recorded in equity, CANNOT be reversed through P&L		

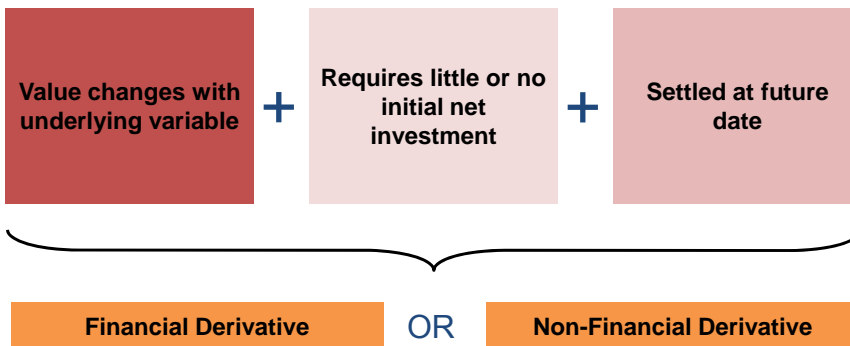
Derivatives

Setting the stage



Definition of a Derivative

A derivative is a financial instrument or other contract with three characteristics



Derivative

Derivative	Underlying	Valuation
<ul style="list-style-type: none"> ▶ Interest rate swaps and options ▶ Stock index futures and stock options ▶ Commodity futures and options ▶ Currency futures and options ▶ Caps, floors, and collars ▶ Swaptions and leaps 	<ul style="list-style-type: none"> ▪ Interest rates ▪ Stock prices ▪ Commodity prices ▪ Exchange rates ▪ Stock prices, interest rates ▪ Interest rates, stock prices 	Fair value



Examples

- Company XYZ enters into a fixed-price forward contract to purchase 1,000 kg of copper in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the copper at the end of twelve months, or to pay or receive a net settlement in cash, based on the change in fair value of copper.



Examples

- Company XYZ owns an office building. It enters into a put option with an investor, which expires in five years and permits it to put the building to the investor for £150 million. The current value of the building is £175 million. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option.



Derivative Instruments to be Discussed

- Futures
- Forwards
- Options
- Swaps



Forwards

- A forward is an **agreement** entered into today, either to **sell** or to **buy** a certain quantity of a **certain asset** at a specified **future date** for a **specified price**.
- It is a tailor-made transaction and its terms are very flexible. (privately negotiated)
- The contracts are generally not assignable or capable of being closed out by offset without the agreement of both parties.

Forward- Example

- A investor entered into a long forward contract on December 5, 2010 to buy £1,000,000 British Pounds in 90 days at an exchange rate of 1.6056. This contract would obligate the investor to buy 1,000,000 for \$1,605,000.
- How do we record the forward contract at December 31, 2010?
- Assume the forward rate calculated is 1.6102 as 31 Dec 2010.

Therefore, the unrealized gain $(1.6102 - 1.6056) \times 1,000,000 \text{ GBP} = 4,600 \text{ USD}$;

Accounting entries:

At the transaction date – 5 December 2010

No entry (Nil)

At the reporting date – 31 December 2010

Forward contract (Dr) 46000 (Assets – FVPL)

Unrealized gain- (Cr) 4,6000 (P&L)

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Futures

- A futures contract is an agreement to buy or sell a **specific amount of a commodity or financial instrument at a particular price on a stipulated future date.**



- Futures contracts benefit from high liquidity, easy price discovery and very low credit risk. Contracts are at a standard format (usually 1,000 contracts, for settlement on quarter dates), and are 100% liquid

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Accounting for Futures

- ▶ No accounting entry is required to record the contract itself. However, details of open contracts are maintained in memorandum format, usually in a futures contract sub ledger
- ▶ Subsequently, the contract is marked-to-market each day that it remains open
 - Variation margin - the change from the previous day's quoted price
 - Recorded as unrealized appreciation/depreciation, together with the related variation margin receivable from/payable to the broker
 - Usually settled in cash with the broker each morning



Accounting for Futures

Journal Entries

- In the event of a gain:
 - Dr. Variation Margin
 - Cr. Unrealized Gain on Futures
- In the event of a loss:
 - Dr. Unrealized Gain on Futures
 - Cr. Variation Margin



- Holder has the *right but not the obligation to buy or sell* a specific asset at a predetermined price. Holder pays premium for this *right*.

- Two basic types:

PUT Options: holder has the right, but not the obligation, to sell an asset to the option writer at a specified price "at any time"* up to the stated expiration date of the contract

CALL Options: holder has the right, but not the obligation, to purchase an asset from the writer at a specified price "at any time"* up to the stated expiration date of the contract

*Only in the American-style option



- Option Terminology:
 - Strike Price: the agreed selling price of the security covered by the option contract
 - Premium: Non-refundable purchase price for the option -paid by the holder to the writer of the option contract
 - Expiration Date: the latest date by which the holder is allowed to exercise his/her rights under the option contract
- Purchaser of a PUT anticipates prices will decline while purchaser of a CALL has opposite bet



Purchased Options (Investments)

- Cost (premium paid) included in investment at cost
 - ▶ Subsequently adjusted for market value changes, included in appreciation/depreciation on investments
 - ▶ Accounting and disclosure is the same for “FVPL”



Written Options:

- Premiums received are recorded as liabilities and subsequently adjusted to the current market value of the option written
- If the current market value of an option exceeds the premium received, the excess is an unrealized loss
- If the premium exceeds the current market value, the excess to the extent of premiums received is an unrealized gain

Written Options:

- Premiums received are recorded as liabilities and subsequently adjusted to the current market value of the option written
- If the current market value of an option exceeds the premium received, the excess is an unrealized loss
- If the premium exceeds the current market value, the excess to the extent of premiums received is an unrealized gain

Written Options (continued):

- After an option is written, the writer's obligation may be discharged in one of the following ways;
 - **Option expires:** realized gain to the extent of premiums received
 - **Option terminated in closing transaction:** realized gain (premium received exceeds cost of closing transaction); or loss (cost of closing transaction exceeds premium received)
 - **Option exercised:**
 - Call Option: gain/loss based on comparison of proceeds and cost of securities sold
 - Put Option: cost basis of security purchased is equal to exercise price plus commission less premium received

Accounting for Options- Example

Written Option:

On December 10, 2005, an entity owns 20,000 shares of IBM with a cost of \$1,000,000 (\$50/share) and a current market value of (\$75/share)

The entity writes a "covered" call option for 10,000 shares of IBM at a strike price of \$72/share, expiring December 31, 2005 and receives a premium of \$50,000 (\$5/share):

Dr. Cash	50,000	
Cr. Liability for option written		50,000

Accounting for Options- Example

Written Option:

- At the time of writing the option the option is not "in the money", since the total cost of exercising the option (\$72+\$5=\$77) exceeds the market value (\$75)
- On December 11, 2005, the market value of the stock increases to \$80/share (assume option increases to \$2):

Dr. Unrealized appreciation/ depreciation of option	20,000	
Cr. Liability for option written		20,000

- On December 12, the holder of the option exercises the option:

Dr. Cash	720,000	
Dr. Liability for option written	70,000	
Cr. Investment		500,000
Cr. Gain on investments		270,000
Cr. Unrealized appreciation/ dep of option	20,000	

Accounting for Options- Example

- **Written Option:**

The gain on sale is comprised of the following:

Proceeds (\$72) less cost (\$50) * 10,000 = 220,000

Proceeds received from sale of option = 50,000

= 270,000

Swaps

- A swap is an agreement between two counterparties to exchange a series of payments over a specified period of time, based on reference rates (interest rates, currencies, commodities, indices) applied to a notional amount.



Types of Swaps

- **Interest Rate Swap** -Contractual agreement in which one party makes a fixed interest rate based on a notional and the other party makes a variable interest rate payment
- **Currency Swap** - Contractual agreement between two parties to exchange two different currencies and then to reverse the exchange at a later date at a specified exchange rate
- **Total Return Swap** -Contractual agreement in which one party agrees to pay fixed or floating interest payment and receives an amount based on the total return of a security or index
- **Credit Default Swap** – Two parties enter into an agreement whereby one party pays the other a fixed periodic coupon for the specified life of the agreement. The other party makes no payments unless a specified credit event occurs.
- **Swaption** – Buyer receives the right to enter into a swap at a future date



Accounting for Swap

- ▶ No initial accounting entry required unless upfront premium is paid by one of the parties
- ▶ Accrual for amounts due at end of current settlement period
- ▶ Fair value the swap at end of each reporting period and record the gain/loss in comprehensive income
- ▶ Example ; Interest rate swap valuations

The value of a swap at any period in time will be equal to the present value of remaining fixed payments less the present value of remaining floating payments. At the inception of the swap, the value should be zero.

The interest rate swap value = PV Fixed – PV Floating

SLFRS 7 Disclosures

SLFRS 7 overview

- SLFRS 7 is effective for annual periods beginning after 1 January 2012
- Combines all financial instrument disclosures into a single standard
- Supersedes SLAS 23 and SLAS 44 disclosures
- Less prescriptive than SLAS 23



SLFRS 7 overview, cont.

- Scope includes all entities in all industries
- No scope exemption for subsidiaries
- Disclosures include both narrative descriptions and specific quantified data
- Level of detail needs to strike a balance between
 - too much - overburdening users with excessive detail and
 - too little - obscuring significant information as a result of too much aggregation
- Financial instruments should be grouped by class based on their appropriateness to the nature of the information disclosed and the characteristics of the instruments



SLFRS 7 overview, cont.

- To provide information
 - to enhance understanding of the significance of financial instruments to an entity's
 - financial position,
 - performance, and
 - cash flows
 - to assist in assessing the amounts, timing, and certainty of future cash flows associated with those instruments.
- Aims to provide the information in the context of risks
 - what could happen to those numbers
 - how that risk is managed



SLFRS 7 overview, cont.

- Financial instruments should be grouped by class based on their appropriateness to the nature of the information disclosed and the characteristics of the instruments



Balance sheet disclosures

- Disclosure permitted on the face of the balance sheet or in the notes to the financial statements
- Focus on disclosure by class of financial instrument
- Additional detail in disclosures for each category of financial instruments



Disclosure of fair value of financial instruments

Danske Bank Annual Report 2006, p.119

Most companies should be familiar with the disclosure of the fair value of financial instruments as this disclosure is currently required by IAS 32. Similar to most companies, Danske Bank presents this information in the notes to the financial statements:

	Carrying amount 2006	Fair value 2006	Carrying amount 2005	Fair value 2005
Financial assets				
Cash in hand and demand deposits with central banks	12,319	12,319	13,881	13,881
Due from credit institutions and central banks	275,260	275,270	274,918	274,918
Trading portfolio assets	490,954	490,954	444,521	444,521
Financial investment securities	26,338	26,357	28,712	28,886
Assets held for sale	1,798	1,814	205	265
Bank loans and advances	1,054,322	1,054,307	828,603	828,603
Mortgage loans	602,584	602,584	569,092	569,092
Assets under pooled schemes and unit-linked investment contracts	38,602	38,602	35,876	35,876
Assets under insurance contracts	194,302	194,302	188,342	188,342
Total	2,697,485	2,697,509	2,394,950	2,394,984
Financial liabilities				
Due to credit institutions and central banks	564,549	564,558	476,363	476,363
Trading portfolio liabilities	238,324	238,324	212,042	212,042
Liabilities held for sale	888	888	-	-
Deposits	702,943	702,943	631,104	631,104
Issued mortgage bonds	484,217	484,217	438,875	438,875
Deposits under pooled schemes and unit-linked investment contracts	46,983	46,983	42,287	42,287
Liabilities under insurance contracts	215,793	215,793	212,328	212,328
Other issued bonds	293,736	294,467	251,098	254,677
Subordinated debt	46,951	50,984	43,837	46,107
Total	2,594,554	2,597,357	2,307,215	2,313,563



Example disclosures – extracts Nordea Annual Report 2007

Note 48:

Classification of financial instruments

Group	Loans and receivables	Held to Maturity	Held for trading	Assets at fair value through profit or loss	Derivatives used for hedging	Available for sale	Non- financial assets	Total
EURm, 31 Dec 2007								
Assets								
Cash and balances with central banks	5,020							5,020
Treasury bills and other eligible bills	10		8,493					8,503
Loans and receivables to credit institutions	14,841		9,421					24,262
Loans and receivables to the public	205,054		7,424	32,204				244,682
Interest-bearing securities		1,632	17,364	16,426		50		35,472
Financial instruments pledged as collateral			4,790					4,790
Shares			5,552	12,076		16		17,644
Derivatives			31,083		415			31,498
Fair value changes of the hedged items in portfolio hedge of interest rate risk	-105							-105
Investments in associated undertakings							366	366
Intangible assets							2,725	2,725
Property and equipment							342	342
Investment property							3,492	3,492
Deferred tax assets							191	191
Current tax assets							142	142
Retirement benefit assets							123	123
Other assets	5,345			2,342			37	7,724
Prepaid expenses and accrued income	1,443		375	5			360	2,183
Total	231,608	1,632	84,502	63,053	415	66	7,778	389,054

Balance sheet disclosures – extracts Nordea Annual Report 2007 (cont'd.)

EURm, 31 Dec 2007	Held for trading	Liabilities at fair value through profit or loss	Derivatives used for hedging	Other financial liabilities	Non-financial liabilities	Total
Liabilities						
Deposits by credit institutions	4,029			26,048		30,077
Deposits and borrowings from the public	2,272	130		139,927		142,329
Liabilities to policyholders	4,224				28,056	32,280
Debt securities in issue	5,072	33,648		61,072		99,792
Derivatives	32,324		699			33,023
Fair value changes of the hedged items in portfolio						
hedge of interest rate risk				-323		-323
Current tax liabilities					300	300
Other liabilities	9,650	3,330		9,563	317	22,860
Accrued expenses and prepaid income	53	5		1,917	787	2,762
Deferred tax liabilities					703	703
Provisions					73	73
Retirement benefit obligations					462	462
Subordinated liabilities				7,556		7,556
Total	57,624	37,113	699	245,760	30,698	371,894

Balance sheet disclosures, cont.

Loans and receivables at fair value through profit or loss disclosures:

- Maximum credit exposure
- Impact of credit derivatives on credit exposure
- Change in fair value of loans and receivables

Balance sheet disclosures, cont.

Danske Bank Annual Report 2006, p.101

Danske Bank designates mortgage loans and issued mortgage bonds to be recorded at fair value through profit or loss and, accordingly, provides the following disclosures:

Mortgage loans and issued mortgage bonds		
Mortgage loans		
Nominal value	608,942	563,153
Fair value adjustment of interest rate risk	-6,290	6,044
Adjustment for credit risk	68	105
Fair value of mortgage loans	602,594	569,092
Issued mortgage bonds		
Nominal value	767,912	737,234
Fair value adjustment of funding of current loans and advances	-6,290	6,044
Fair value adjustment of pre-issued bonds	-549	-1,340
Holding of own mortgage bonds	276,856	303,263
Fair value of issued mortgage bonds	484,217	438,675

The nominal value of issued mortgage bonds equals the amount to be repaid on expiry. Of the total adjustment for credit risk on mortgage loans, changes in 2006 amounted to an income of DKK37m (2005: income of DKK134m).

Changes in the fair value of own credit risk amounted to DKK0 of the total fair value adjustment of issued mortgage bonds (2005: DKK0). The change in fair value of the credit risk is calculated as the change triggered by factors other than changes in the benchmark interest rate, which is the average yield on Danish mortgage bonds with AAA ratings. Changes in 2006 accounted for DKK0 of the accumulated effect (2005: DKK0).

Balance sheet disclosures, cont.

Financial liabilities at fair value through profit or loss disclosures:

- Change in fair value of financial liability due to credit risk
- Method used to determine such change in fair value

Required method to estimate the change in fair value due to credit risk outlined in SLFRS 7 AG.

HSBC Holdings plc Annual Report and Accounts 2006, p.372

HSBC designates financial liabilities to be carried at fair value through profit or loss and, accordingly, provides the following disclosures:

27 Financial liabilities designated at fair value

HSBC

	2006 US\$m	2005 US\$m
Deposits by banks and customer accounts	877	253
Liabilities to customers under investment contracts	13,278	10,445
Debt securities in issue (Note 28)	22,167	28,338
Subordinated liabilities (Note 32)	18,503	18,447
Preference shares (Note 32)	4,686	4,346
	70,211	61,829

The carrying amount at 31 December 2006 of financial liabilities designated at fair value was US\$1,257 million (2005: US\$1,899 million) higher than the contractual amount at maturity. At 31 December 2006, the accumulated amount of the change in fair value attributable to changes in credit risk was US\$1,535 million (2005: US\$1,144 million).

Other sundry disclosures:

- Derecognition: nature and carrying amount of transferred but not derecognized
- Collateral given: terms and conditions, and carrying amount
- Collateral received: terms and conditions, fair value, and whether such collateral has been sold or repledged

Balance sheet disclosures, cont.

HSBC Holdings plc Annual Report and Accounts 2006, p.359

HSBC provides the following disclosure of the impact of financial assets that have been transferred but that do not qualify for derecognition:

The majority of financial assets that do not qualify for derecognition are (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) equity securities lent under securities lending agreements. The following table analyses the carrying amount of financial assets that did not qualify for derecognition during 2006 and 2005, and their associated financial liabilities:

	2006		2005	
	Carrying amount of transferred assets US\$m	Carrying amount of associated liabilities US\$m	Carrying amount of transferred assets ¹ US\$m	Carrying amount of associated liabilities ¹ US\$m
Nature of transaction				
Repurchase agreements	67,558	66,127	62,663	62,880
Securities lending agreements	12,908	12,469	4,138	4,281
	80,466	78,596	66,801	67,161

1. 2005 amounts for repurchase agreements and securities lending agreements have been reclassified to ensure a consistent presentation with 2006 balances for this disclosure.

Balance sheet disclosures, cont.

Danske Bank Annual Report 2006, p.101

Danske Bank designates mortgage loans and issued mortgage bonds to be recorded at fair value through profit or loss and, accordingly, provides the following disclosures:

Mortgage loans and issued mortgage bonds		
Mortgage loans		
Nominal value	606,942	563,153
Fair value adjustment of interest rate risk	-6,290	6,044
Adjustment for credit risk	88	105
Fair value of mortgage loans	600,740	569,292
Issued mortgage bonds		
Nominal value	767,912	737,234
Fair value adjustment of funding of current loans and advances	-6,290	6,044
Fair value adjustment of pre-issued bonds	-548	-1,340
Holding of own mortgage bonds	276,896	303,263
Fair value of issued mortgage bonds	484,217	438,675

The nominal value of issued mortgage bonds equals the amount to be repaid on expiry. Of the total adjustment for credit risk on mortgage loans, changes in 2006 amounted to an income of Dkr37m (2005: income of Dkr134m).

Changes in the fair value of own credit risk amounted to Dkr0 of the total fair value adjustment of issued mortgage bonds (2005: Dkr0). The change in fair value of the credit risk is calculated as the change triggered by factors other than changes in the benchmark interest rate, which is the average yield on Danish mortgage bonds with AAA ratings. Changes in 2006 accounted for Dkr0 of the accumulated effect (2005: Dkr0).

Balance sheet disclosures, cont.

Other sundry disclosures, cont.:

- Allowance for credit losses: reconciliation for each class of financial asset
- Compound financial instruments: multiple embedded derivatives whose values are interdependent
- Defaults and breaches: carrying amount and details of defaults for loans payable
- Reclassification of financial assets: the amounts reclassified in and out of each category, with reasons

Danske Bank Annual Report 2006, p.101

Impairment charges		
At January 1	4,760	6,174
New and increased impairment charges	1,672	2,848
Reversal of impairment charges	2,539	4,428
Foreign currency translation	-3	44
Other additions and disposals	35	121
At December 31	3,925	4,760

Deutsche Telekom Financial Review 2006, p.147

The following table shows the development of allowances on trade receivables:

millions of €	2006	2005
Allowances as of January 1	1,108	1,845
Currency translation adjustments	(20)	22
Additions (allowances recognized as expense)	534	541
Use	(425)	(356)
Reversal	(40)	(106)
Allowances as of December 31	1,148	1,108

The total additions of EUR 534 million (2005: EUR 541 million) relate to allowances for individual impairments of EUR 152 million (2005: EUR 208 million) and allowances for collective impairments of EUR 382 million (2005: EUR 333 million). The reversals include reversals of allowances for individual impairments of EUR 44 million (2005: EUR 65 million) and reversals of allowances for collective impairments of EUR 62 million (2005: EUR 58 million).

Balance sheet disclosures, cont.

Nordea Annual Report 2006, p.137

Nordea presents a reconciliation of allowances for both the individually and the collectively assessed impaired loans, whereas most companies disclose a reconciliation of the total allowance for credit losses:

EURm	Group		Total
	Allowances for individually assessed impaired loans	Allowances for collectively assessed impaired loans	
Opening balance at 1 Jan 2006	-1,057	-406	-1,463
Provisions	-276	-187	-463
Reversals	463	231	694
Changes through the income statement	187	44	231
Allowances used to cover write-offs	134	-	134
Currency translation differences	-21	21	0
Closing balance at 31 Dec 2006	-757	-341	-1,098

Balance sheet disclosures, cont.

HSBC Holdings plc Annual Report and Accounts 2006, p.359

HSBC provides the following disclosure of the impact of financial assets that have been transferred but that do not qualify for derecognition:

The majority of financial assets that do not qualify for derecognition are (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) equity securities lent under securities lending agreements. The following table analyses the carrying amount of financial assets that did not qualify for derecognition during 2006 and 2005, and their associated financial liabilities:

Nature of transaction	2006		2005	
	Carrying amount of transferred assets US\$m	Carrying amount of associated liabilities US\$m	Carrying amount of transferred assets ¹ US\$m	Carrying amount of associated liabilities US\$m
Repurchase agreements	67,558	66,127	62,653	62,880
Securities lending agreements	12,908	12,469	4,138	4,281
	80,466	78,596	66,811	67,161

¹ 2005 amounts for repurchase agreements and securities lending agreements have been reclassified to ensure a consistent presentation with 2006 balances for this disclosure.

Income statement disclosures

- Disclosure permitted on the face of the income statement or in the notes to the financial statements
- Focus on disclosure by class of financial instrument
- Additional detail in disclosures for each category of financial instruments

Balance sheet disclosures, cont.

2 Net interest and net trading income	Interest income	Interest expense	Net interest income	Net trading income	Total
2006					
Financial portfolio at amortized cost					
Due from/to credit institutions and central banks	17,338	30,043	-12,705	-187	-12,892
Repo and reverse repo transactions	15,079	8,268	6,811	-	6,811
Bank loans, advances and deposits	34,633	12,584	22,049	876	22,925
Held-to-maturity investments	174	-	174	-	174
Other interest-bearing assets	-	10,217	-10,217	780	-9,437
Subordinated debt	-	2,078	-2,078	1,712	-366
Other financial instruments	-	-	-	-	-
Total	66,076	61,007	4,969	1,489	6,458
Financial portfolio at fair value					
Mortgage loans and issued mortgage bonds	24,287	18,119	6,168	540	6,708
Trading portfolio and investment securities	10,963	-	10,963	4,830	15,793
Assets and liabilities under pooled schemes and unit-linked investment contracts	-	-	-	364	364
Assets and liabilities under insurance contracts	5,788	-	5,788	1,812	7,600
Total	40,948	18,119	22,829	7,546	30,375
Total net interest and net trading income	106,724	79,126	27,598	8,995	36,593

Deutsche Telekom Financial Review 2006, p.138

Deutsche Telekom discloses the net gains or net losses for each category of financial instruments included in total interest income and expense:

7 Finance costs			
millions of €	2006	2005	2004
Interest income	287	308	377
Interest expense	(6,337)	(6,798)	(6,657)
	(6,050)	(6,490)	(6,280)
Of which: from financial instruments relating to categories in accordance with IAS 39			
Loans and receivables	262	229	198
Held-to-maturity investments	14	2	12
Available-for-sale financial assets	27	56	87
Financial facilities measured at amortized cost*	(6,338)	(6,519)	(6,432)

*These amounts are calculated using the effective interest method and adjusted for accrued income from derivatives that were used for hedging instruments against movements based on changes in the fair value of financial liabilities or assets measured at cost in the reporting period to hedge accounting in accordance with IAS 39 (2006). Interest income of €1,872 million, interest expense of €1,131 million, 2005: interest income of €1,872 million, interest expense of €1,131 million.

Income statement disclosures, cont.

- Net gains (losses) for each category of financial instrument, including AFS gains (losses) recognized in equity and amounts reclassified from equity to profit or loss
- Total interest income and total interest expense (other than FVPL)
- Fee income and expense for financial instruments (other than FVPL)

Income statement disclosures, cont.

HSBC Holdings plc Annual Report and Accounts 2006, p.319

HSBC provides information about the components of net operating income in the notes to the financial statements:

	2006 US\$m	2005 US\$m
Income		
Interest recognised on impaired financial assets	284	120
Fees earned on financial assets or liabilities not held for trading or designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	11,182	9,077
Fees earned on trust and other fiduciary activities where HSBC holds or invests assets on behalf of its customers	7,909	7,917
Income from listed investments ¹	7,304	6,819
Income from unlisted investments ²	9,192	5,001
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	(38,158)	(26,627)
Fees payable on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	(1,826)	(1,357)
Fees payable relating to trust and other fiduciary activities where HSBC holds or invests assets on behalf of its customers	(103)	(238)

Income statement disclosures, cont.

- Interest income accrued on impaired financial assets
- Impairment losses for each class of financial assets

Income statement disclosures, cont.

HSBC Holdings plc Annual Report and Accounts 2006, p.305-306

Individually assessed loans

At each balance sheet date, HSBC assesses on a case-by-case basis whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining impairment losses on these loans, the following factors are considered:

- HSBC's aggregate exposure to the customer;
- the viability of the customer's business model and their capability to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, HSBC and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

Income statement disclosures, cont.

Danske Bank Annual Report 2006 p.68

Objective evidence of impairment of loans and advances exists if at least one of the following events has occurred:

- the borrower is experiencing significant financial difficulty
- the borrower's actions, such as default on interest or principal payments, lead to a breach of contract
- the Group, for reasons relating to the borrower's financial difficulty, grants to the borrower a concession that the Group would not otherwise have granted, or
- it becomes probable that the borrower will enter bankruptcy or other financial reorganisation

Disclosure on accounting policies

Disclosure required by SLFRS 7 and LKAS 1:

- the significant accounting policies adopted
- measurement basis used to apply those policies

Application guidance includes the following examples of disclosures appropriate for financial instruments:

- FVPL (nature, criteria for designation, which conditions for designation are met)
- The criteria for designation as AFS
- Whether trade date or settlement date is used for regular way purchases and sales
- Allowance for credit losses, including criteria for write-offs)

- Application guidance examples (continued):
 - Determination of net gains or net losses for each category
 - Criteria to determine objective evidence of impairment
 - Renegotiated financial assets that would otherwise be considered impaired (or past due)

Hedge accounting disclosures

Disclosure	Fair value hedges	Cash flow hedges	Net investment hedges
Description of hedged risk and hedging instrument with related fair values	x	x	x
When hedged cash flows are expected to occur		x	
Forecast transactions no longer expected to occur		x	
Gain or loss recognized in equity and reclassifications to P&L		x	
Gain or loss from hedging instrument and hedged risk	x		
Ineffectiveness recognized in P&L		x	x

Fair value disclosures

- Fair value for each class of financial instruments compared with its carrying amount
- Methods and significant assumptions used to determine fair value for each class of financial instruments
- Financial instruments whose carrying value approximates fair value exempt from required disclosures



Fair value disclosures

HSBC Holdings plc Annual Report and Accounts 2006, p.305

HSBC provides the following information about its accounting policies for determining the value of financial instruments:

(d) Determination of fair value

All financial instruments are recognised initially at fair value. The fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received. In certain circumstances, however, the initial fair value may be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

For certain derivatives, fair values may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data.

A number of factors such as bid-offer spread, credit profile and model uncertainty are taken into account, as appropriate, when fair values are calculated using valuation techniques.

If the fair value of a financial asset measured at fair value becomes negative, it is recorded as a financial liability until its fair value becomes positive, at which time it is recorded as a financial asset, or it is extinguished.



Fair value disclosures, cont.

- Whether the fair value is based on quoted prices or valuation techniques
- Whether the fair value is based on a valuation technique that includes assumptions not supported by market prices or rates, and the amount of profit recognized
- The effect of reasonably possible alternative assumptions used in a valuation technique

Fair value disclosures, cont.

Note 30 Fair Value of Financial Instruments and Continued Recognition of Transferred Financial Assets (cont.) b) Determination of Fair Values from Quoted Market Prices or Valuation Techniques

For trading portfolio assets and liabilities, financial assets and liabilities designated at fair value and financial investments available-for-sale which are listed or otherwise traded in an active market, for exchange traded derivatives, and for other financial instruments for which quoted prices in an active market are available, fair value is determined directly from those quoted market prices.

For financial instruments which do not have quoted market prices directly available, fair values are estimated using valuation techniques or models based wherever possible on assumptions supported by observable market prices or rates prevailing at the balance sheet date. This is the case for the majority of OTC derivatives, and for many unlisted instruments and other items which are not traded in active markets.

For a small portion of financial instruments, fair values cannot be obtained directly from quoted market prices, or indirectly using valuation techniques or models supported by observable market prices or rates. This is generally the case for private equity investments in unlisted securities, and for certain complex or structured financial instruments. In these cases, fair value is estimated indirectly using valuation techniques or models for which the inputs are reasonable assumptions, based on market conditions.

The following table presents the valuation methods used to determine fair values of financial instruments carried at fair value:

	31.12.06			31.12.05				
	Quoted market price	Valuation technique – market-observable inputs	Valuation technique – non-market-observable inputs	Total	Quoted market price	Valuation technique – market-observable inputs	Valuation technique – non-market-observable inputs	Total
CHF million								
Trading portfolio assets	215.1	411.8	0.1	627.3	271.2	215.2	0.9	489.3
Trading portfolio assets pledged as collateral	243.5	8.0	0.0	251.5	147.6	7.2	0.0	154.8
Positive replacement value	31.3	248.4	11.5	290.9	11.6	312.0	6.8	233.9
Financial assets designated at fair value	0.0	5.1	0.0	5.9	4.2	1.0	0.0	1.2
Financial investments available-for-sale	2.5	4.6	1.8	8.9	1.0	1.1	2.5	6.6
Total assets	492.4	715.1	14.2	1,221.7	437.6	587.9	10.2	995.7
Trading portfolio liabilities	169.9	34.9	0.0	204.8	171.2	17.4	0.0	188.6
Negative replacement values	32.7	290.6	9.2	332.5	11.9	311.1	10.7	337.7
Financial liabilities designated at fair value	0.0	80.0	85.7	145.7	6.0	32.5	24.9	117.4
Total liabilities	202.6	405.5	94.9	683.0	189.1	411.0	35.6	643.7

Fair value disclosures, cont.

Required disclosure for financial instruments whose fair value cannot be reliably measured:

- Nature and carrying amount
- How the entity intends to dispose of such instrument



Risk disclosures

- Combination of qualitative and quantitative risk disclosures with the objective to
“.....disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.”



Risk disclosures, cont.

Risks include but are not limited to:

- Credit
- Liquidity
- Market (interest rate, currency, other price)



Qualitative risk disclosures

- Expands qualitative risk disclosures
- Description of financial risk management objectives and policies, including any hedging of forecast transactions



Qualitative risk disclosures, cont.

- Intended to provide information about the extent to which an entity is exposed to risks
- Quantitative data is based on information provided internally to management
- Description of how management determines concentrations of risk
- Description of shared characteristics for each concentration of risk



Credit risk disclosures

For each class of financial instrument, disclose the maximum credit exposure without taking into consideration collateral or other credit enhancements



Credit risk disclosures, cont.

New credit risk disclosures:

- information relating to the credit quality of financial assets that are neither past due nor impaired (e.g., a rating analysis);
- a description and fair value of collateral available to the entity as security and other credit enhancements; and
- collateral for which the entity has taken control.

Credit risk disclosures, cont.

Danske Bank Annual Report 2006, p.123

Danske Bank provides the required disclosure of maximum credit exposure in the risk management section of the notes to the financial statements:

Credit exposure			2006	2005		
The credit exposure is calculated on the basis of selected items on and off the balance sheet.						
Balance sheet items						
Demand deposits with central banks			2,603	5,569		
Due from credit institutions and central banks			275,268	274,918		
Bank loans and advances			1,054,322	625,603		
Mortgage loans			602,584	569,082		
Off balance sheet items						
Guarantees			80,568	81,089		
Loan commitments < 1 year			140,233	97,102		
Loan commitments > 1 year			113,365	103,715		
Total			2,274,924	1,861,118		
Trading activities						
Trading portfolio assets			493,954	444,501		
Financial investment securities			26,338	28,719		
Total			517,292	473,220		
Credit exposure includes items with credit risk that form part of the Group's core banking operations. Trading activities includes items with credit risk that form part of its trading-related activities.						
Credit exposure - trading activities						
			2006	2005		
Bonds			363,715	318,983		
Shares			4,048	5,362		
Derivatives with positive market value			148,529	148,889		
Total			517,292	473,233		
Bonds						
	Investment grade	Non-investment grade	Total	Investment grade	Non-investment grade	Total
Government bonds	64,301	-	64,301	105,237	23	105,260
Mortgage bonds	258,809	87	258,896	181,048	484	181,532
Other bonds	36,746	1,792	40,538	31,642	548	32,190
Total	361,856	1,879	363,735	317,927	1,055	318,982

Credit risk disclosures, cont.

Danske Bank Annual Report 2006, p.124-125

The required credit risk disclosures may, among other items, include a distribution of loans by industry sector and geographical location, such as the following provided by Danske Bank:

Exposure broken down by industry (DICS)									
	2006								
	Retail personal customers	Retail business customers	Corporate customers	Institu- tional	Securiti- zation	2006 Total	2005 Total		
Retail customers	706,900	-	-	-	-	706,900	615,312		
Retail housing companies, etc.	-	8,188	100,357	-	-	108,545	136,205		
Government	-	-	-	-	34,402	34,402	44,150		
Credit institutions	-	-	296,263	22,807	5,946	325,016	333,147		
Financials	-	10,286	376,244	241,215	-	627,745	428,807		
Energy	-	84	7,418	-	-	7,502	8,502		
Materials	-	1,249	36,309	-	-	37,558	37,100		
Industrials	-	9,331	145,973	-	-	155,304	126,589		
Consumer discretionary and consumer staples	-	23,874	148,079	-	-	171,953	187,074		
Health care	-	1,560	30,899	-	-	32,459	19,395		
IT	-	772	10,108	-	-	10,880	9,808		
Telecommunications	-	27	7,524	-	-	7,551	7,966		
Utilities	-	1,185	11,805	-	-	12,990	13,974		
Total	706,900	56,532	602,047	537,490	57,259	2,274,924	1,861,118		

Exposure broken down by geographical area									
	2006				2005				
	Financial customers	Non-financial customers	Total	%	Financial customers	Non-financial customers	Total	%	
European Union	791,209	1,180,702	1,971,911	86.4	972,776	1,094,511	2,067,287	85.0	
including Denmark	193,159	882,740	1,075,899	47.3	187,987	843,009	1,031,006	51.6	
Germany	17,890	17,205	35,095	1.5	13,804	12,803	26,607	1.4	
Republic of Ireland	28,940	40,010	68,950	3.0	11,871	26,774	38,645	2.0	
Sweden	105,831	125,639	231,470	10.2	76,198	111,879	188,077	9.6	
UK	388,521	84,361	472,882	19.8	250,195	70,958	321,153	16.4	
Eastern Europe	1,011	456	1,467	0.1	651	360	1,011	0.1	
Rest of Europe	57,742	87,470	145,212	6.8	60,092	89,237	149,329	7.6	
including Norway	48,911	86,840	135,751	6.4	52,514	84,777	137,291	7.0	
North America	100,907	11,114	112,021	5.1	115,569	16,475	132,044	6.8	
Central and South America	1,300	361	1,661	0.1	715	1,512	2,227	0.1	
Africa	509	330	839	0.0	220	163	383	0.0	
Asia	7,446	2,029	9,475	0.4	6,840	1,567	8,407	0.4	
Oceania	913	887	1,800	0.1	91	339	430	0.0	
Total	1,001,567	1,273,387	2,274,954	100.0	756,954	1,204,164	1,961,118	100.0	

Credit risk disclosures, cont.

Deutsche Telekom 2006 Financial Review, p.146

Deutsche Telekom provides the analysis of the age of past due loans and receivables in the notes to the financial statements:

In million EUR	Carrying amount	Of which: provision for past due receivables	Of which: not reported on the reporting date and past due in the following periods					
			less than 30 days	between 30 and 60 days	between 61 and 90 days	between 91 and 180 days	between 181 and 360 days	more than 360 days
Trade receivables	as at Dec 31, 2006	7,577	4,443	812	120	85	89	121
Trade receivables	as at Dec 31, 2005	7,028	4,330	705	107	62	55	161

Deutsche Telekom 2006 Annual Report, p.188

Credit risks.
Deutsche Telekom is exposed to credit risk from its operating activities and certain financing activities. With regard to financing activities, transactions are only concluded with counterparties that have at least a credit rating of BBB- (Baa1). In connection with an operational management system, at the level of operations, the outstanding debts are continuously monitored in each area, i.e., locally. Credit risks must be taken into account through individual and collective impairments.

In the course of ABS transactions, receivables from the bulk business are managed separately. A security margin is provided as a cash reserve for the credit risk. The percentage of the provision for the credit risk has been statistically proven to be stable. A statement of the actual loss losses is prepared periodically and any excess payments to the cash reserve are refunded.

The solvency of the business with key accounts, in particular international carriers, is monitored separately. In terms of the overall risk exposure from credit risk, however, the receivables from these counterparties are not so extensive as to justify extraordinary concentrations of risk.

The maximum exposure to credit risk is partly represented by the carrying amounts of the financial assets that are carried in the balance sheet, including derivatives with positive market values. Except for the collateral agreements mentioned in Note 24, no significant agreements reducing the maximum exposure to credit risk (such as contractual netting) had been concluded as of the reporting date. In addition, Deutsche Telekom is exposed to credit risk through the granting of financial guarantees. Guarantees amounting to a nominal total of EUR 216 million had been pledged as of the reporting date.

Collateral and other credit enhancements obtained

(continued)

HSBC obtained assets by taking possession of collateral held as security, or calling upon other credit enhancements, as follows:

(continued)

Nature of assets	Carrying amount obtained in:	
	2006 US\$m	2005 US\$m
Residential property	1,716	1,171
Commercial and industrial property	4	26
Other	215	138
	1,937	1,335

Repossessed properties are made available for sale in an orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. Where excess funds are available after the debt has been repaid, they are available either for other secured lenders with lower priority or are returned to the customer. HSBC does not generally occupy repossessed properties for its business use. The majority of repossessed properties arose in HSBC Finance.

Credit risk disclosures, cont.

Extract 13: Example of an analysis of credit exposure by internal ratings for banking products and traded products from UBS' Annual Report 2007, page 19

Gross credit exposure by UBS internal ratings

Audited CHF million	Banking products		Traded products		Total exposure	
UBS internal rating	31.12.07	31.12.06	31.12.07	31.12.06	31.12.07	31.12.06
0-1	30,540	5,265	42,852	34,148	73,392	39,413
2-3	164,476	135,149	98,454	95,449	262,930	230,598
4-5	113,955	119,926	15,210	19,973	129,165	139,899
6-8	76,601	94,278	7,566	8,084	84,167	102,362
9-12	38,875	44,711	915	760	39,790	45,471
Total 0-12 (net of past due)	424,447	399,329	164,997	158,414	589,444	557,743
Impaired assets	2,433	2,682	975	188	3,408	2,870
Past due but not impaired	2,268	3,370			2,268	3,370
Total	429,148	405,381	165,972	158,602	595,120	563,983

Liquidity risk disclosures

Required disclosures:

- analysis of remaining contractual maturities for all financial liabilities; and
- description of how the entity manages liquidity risk.

Liquidity risk disclosures – contd..

Novartis Annual Report 2006, p.183 and 185

Novartis discloses the contractual maturities of its financial assets, as well as the contractual maturities for financial liabilities in the notes to the financial statements. This disclosure is supplemented by a discussion of how the company manages its liquidity risk, also located in the notes to the financial statements:

The following table sets forth details of the remaining contractual maturities of financial assets and liabilities excluding trade accounts receivable and payable as at December 31, 2006 and 2005:

	Due or due within twelve months USD millions	Due later than one month but not later than three months USD millions	Due later than three months but not later than one year USD millions	Due later than one year but not later than five years USD millions	Due later than five years USD millions	Total
December 31, 2006						
Current assets						
Marketable securities	16	42	929	1 726	1 390	4 103
Derivative financial instruments and accrued interest on derivative financial instruments	12	24	1			37
Cash and cash equivalents	3 014	801				3 815
Total current assets	3 042	867	930	1 726	1 390	7 955
Non-current liabilities						
Financial debts				656		656
Total non-current liabilities				656		656
Current liabilities						
Financial debts	3 438	1 352	1 770			6 560
Derivative financial instruments	4	3	24	3		34
Total current liabilities	3 442	1 355	1 794	3		6 644
Net liquidity of continuing operations	-400	-488	-664	1 062	1 390	656

Liquidity risk

Liquidity risk is defined as the risk that the Group could not be able to settle or meet its obligations on time or at a reasonable price. Group Treasury is responsible for liquidity, funding as well as settlement management. In addition, liquidity and funding risks, related processes and policies are overseen by management. Novartis manages its liquidity risk on a consolidated basis based on business needs, tax, capital or regulatory considerations, if applicable, through numerous sources of finance in order to maintain flexibility.

Liquidity risk disclosures – contd..

Description of how liquidity risk inherent in financial liabilities is managed

Factors mentioned in the Implementation Guidance that the “company might consider” in describing how it manages its liquidity risks include whether the company:

- expects some liabilities may be paid later than the earliest contractual due date
- has undrawn loan commitments that are not expected to be drawn
- holds financial assets for which there is a liquid market and are, therefore, readily saleable to meet liquidity needs
- has committed borrowing facilities which it could use to help provide liquidity
- holds deposits at central banks that it can use to meet liquidity needs
- holds financial assets which are not traded in a liquid market, but which can be expected to generate cash inflows that will be available to meet cash outflows on liabilities
- has diverse funding sources
- has significant concentration of liquidity risk in either its assets or its funding sources.

Liquidity risk disclosures – contd..

Extract 15: Example of the contractual maturity analysis, including the fair value of derivative instruments from HBOS' Annual Report 2007, page 22

45 Liquidity Risk continued

Group	Up to 1 month £m	1 to 3 months £m	3 to 12 months £m	1 to 5 years £m	2007 Over 5 years £m
Liabilities					
Deposits by banks	23,563	12,413	4,369	629	673
Customer accounts	193,031	19,276	25,220	7,934	1,642
Financial liabilities held for trading	9,119	5,556	6,540	242	
Derivative liabilities:					
Gross settled derivatives – outflows	20,580	21,966	15,575	39,030	15,700
Gross settled derivatives – inflows	(20,558)	(22,084)	(15,298)	(38,324)	(14,998)
Gross settled derivatives – net flows	22	(118)	277	706	702
Net settled derivative liabilities	332	516	1,347	4,133	(400)
	354	398	1,624	4,839	302
Insurance contract liabilities	99	61	495	1,185	1,821
Investment contract liabilities	1	2	1,907	13	98
Debt securities in issue	26,990	48,086	42,900	75,693	36,843
Other borrowed funds	48	246	2,145	11,776	23,911
Other financial liabilities	914				
	254,119	86,038	85,200	102,311	65,290

Liquidity risk disclosures – contd..

Extract 16: Example of alternative liquidity management technique from HSBC's Annual Report 2007, page 246

Ratio of net liquid assets to customer liabilities and net liquid assets

(Audited)

	Year ended 31 December 2007		Year ended 31 December 2006	
	Ratio %	Net liquid assets US\$bn	Ratio %	Net liquid assets US\$bn
HSBC Bank (UK operations)				
Year-end	12.1	44.2	16.3	48.7
Maximum	21.5	80.6	19.1	50.1
Minimum	12.1	39.9	12.8	32.9
Average	15.6	52.4	15.1	40.1

Liquidity risk disclosures – contd..

HSBC Holdings plc Annual Report and Accounts 2006, p.213-214

HSBC includes both the qualitative discussion of the process used to manage liquidity risk and the required liquidity analysis of financial liabilities in the financial review section of its annual report:

The Group's liquidity and funding management process includes:

- projecting cash flows by major currency and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- maintaining debt financing plans;
- monitoring depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Cash flows payable by HSBC under financial liabilities by remaining contractual maturities

(Audited)

	On demand US\$bn	Due within 3 months US\$bn	Due between 3 and 12 months US\$bn	Due between 1 and 5 years US\$bn	Due after 5 years US\$bn
At 31 December 2006					
Deposits by banks	29,609	55,239	8,462	4,356	4,893
Customer accounts	535,695	301,847	47,560	221,505	5,429
Financial liabilities designated at fair value	8,990	1,103	2,855	36,194	52,222
Debt securities in issue	919	80,238	38,331	112,009	51,171
Subordinated liabilities	-	285	1,296	11,221	36,744
Other financial liabilities	14,824	35,404	1,378	1,542	878
	590,037	474,026	100,082	182,528	145,248



Market risk disclosures

- Introduces disclosure of market risk sensitivity analysis
- Market risk is *“the risk that the fair value or future cash flows of a financial instruments will fluctuate because of changes in market prices and includes interest rate risk, foreign currency risk and other price risk.”*



Market risk disclosures, cont.

- No prescribed format
- Similar risks are combined for purposes of the market risk analysis
- Disclosure of assumptions and methods used in the market risk analysis

Market risk disclosures, cont.

Market risk sensitivity analysis includes the effect of *'a reasonably possible change'* in risk variables in existence at balance sheet date if applied to all risks in existence at that date.

Reasonable possible change is not remote or *'worst-case'* scenarios or *'stress tests'*.

Liquidity risk disclosures – contd..

Deutsche Telekom 2006 Financial Review p 186-187

Deutsche Telekom provides a sensitivity analysis in the notes to the financial statements to illustrate the impact on profit or loss and equity of changes in currency rates. The following is an excerpt that describes the risk and the impact on the financial statements:

The currency sensitivity analysis is based on the following assumptions:
Major non-derivative monetary financial instruments (liquid assets, receivables, interest-bearing securities and/or debt instruments held, interest-bearing liabilities, financial lease liabilities, liabilities arising from joint ventures, etc.) are not interest-bearing liabilities and are not directly denominated in the functional currency or are transferred to the functional currency through the use of derivatives. Exchange rate fluctuations therefore have no effect on profit or loss, or shareholders' equity.

Non-interest-bearing securities or equity instruments held are of a non-monetary nature and therefore are not exposed to currency risk as defined by IAS 32.

Interest income and interest expense from financial instruments are also either recorded directly in the functional currency or transferred to the functional currency by using derivatives. For this reason, there can be no effect on the variables considered in this connection.

In the case of fair value hedges designed for hedging currency risks, the changes in the fair value of the hedged item and the hedging instruments attributable to exchange rate movements balance out almost completely in the income statement in the same period. As a consequence, these financial instruments are not exposed to currency risks with an effect on profit or loss, or shareholders' equity either.

Cross currency swaps are always assigned to non-derivative hedged items, so that instruments also do not have any currency effects.

Deutsche Telekom is therefore only exposed to currency risks from specific currency instruments. Some of these are currency derivatives that are part of an effective cash flow hedge for hedging payment fluctuations resulting from exchange rate movements in accordance with IAS 39. Exchange rate fluctuations of the currencies in which these transactions are based affect the hedging income in shareholders' equity and the fair value of these hedging transactions. There are currency derivatives that are neither part of one of the hedges defined in IAS 39 nor part of a natural hedge. These derivatives are used to hedge planned transactions. Exchange rate fluctuations of the currencies, in which such financial instruments are based, affect other financial income or expense (not gains/loss from measurement of financial assets to be realized).

If the euro had gained (lost) 10 percent against the U.S. dollar at December 31, 2006, the hedging income in shareholders' equity and the fair value of the hedging instruments would have been EUR 125 million lower (higher) (December 31, 2005: EUR 60 million higher/lower).

If the euro had gained (lost) 10 percent against all currencies at December 31, 2006, other financial income and the fair value of the hedging instruments would have been EUR 20 million higher/lower (December 31, 2005: EUR 3 million higher/lower). The hypothetical effect on profit or loss of EUR -20 million results from the currency sensitivity EUR/USD: EUR -14 million, EUR/JPY: EUR -1 million, EUR/GBP: EUR -4 million, EUR/CHF: EUR -1 million, EUR/PLN: EUR -22 million, EUR/SEK: EUR -4 million.

Liquidity risk disclosures – contd..

Novartis Annual Report 2006, p.184

Novartis uses a VaR model to measure the impact of the market risk relating to its financial instruments and includes the average, maximum, and minimum VaR, along with the year-end amounts:

Value at risk			
<p>The Group uses a value at risk (VaR) computation to estimate the potential ten-day loss in the fair value of its financial instruments. It uses a ten day period because of an assumption that not all positions could be undone in a single day given the size of the positions. The VaR computation includes the Group's financial debt, short-term and long-term investments, foreign currency forwards, swaps and options as well as anticipated transactions. Foreign currency trade payables and receivables as well as net investments in foreign subsidiaries are included in the computation.</p> <p>The VaR estimates are made assuming normal market conditions, using a 95% confidence interval. The Group uses a "Delta Normal" model to determine the observed inter-relationships between movements in interest rates, stock markets and various currencies. These inter-relationships are determined by observing interest rate, stock market movements and forward currency rate movements over a 60 day period for the calculation of VaR amounts. The estimated potential ten day loss in pre-tax earnings from the Group's foreign currency instruments, the estimated potential ten day loss on its equity holdings, and the estimated potential ten day loss in fair value of its interest rate sensitive instruments, primarily financial debt and investments of liquid funds under normal market conditions, as calculated in the VaR model, are the following:</p>			
	Dec 31, 2006 USD million	Dec 31, 2005 USD million	
All financial instruments	49	113	
Analysed by components:			
Instruments sensitive to foreign currency rates	30	108	
Instruments sensitive to equity market movements	28	22	
Instruments sensitive to interest rates	27	4	
The average, high, and low VaR amounts for 2006 are as follows:			
	Average USD million	High USD million	Low USD million
All financial instruments	90	138	49
Analysed by components:			
Instruments sensitive to foreign currency rates	81	134	30
Instruments sensitive to equity market movements	29	40	21
Instruments sensitive to interest rates	11	29	4

Value at Risk

If the entity uses VaR, it must explain the method used and the parameters and assumptions underlying the data provided. These will usually include:

- ▶ the data collection period for historical price information;
- ▶ the period over which positions are expected to be held (and, so, the modelled losses incurred); and
- ▶ the confidence level at which the calculation is made, i.e., the percentage number of holding periods in which losses are expected to be less than the calculated VaR.

Figure 11: Confidence level and holding periods used by the banks in their VaR analyses

		Confidence interval			
		99%	98%	97.50%	95%
Holding period	1 day	14	1	2	2
	10 days	3	0	0	1
	1 month	1	0	0	0

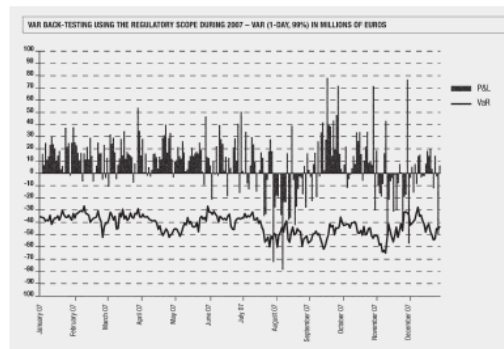


LIMITATIONS OF THE HISTORICAL VaR CALCULATION

The main methodological limits relating to the VaR model are as follows:

- the use of one-day shocks assumes that all positions can be liquidated or covered in one day, which is not always the case for certain products and certain crisis situations,
- the use of a 99% confidence interval excludes losses that may occur outside of this interval: VaR is therefore an indicator of risk in normal market conditions, which does not take into account movements that are exceptional in scale,
- VaR does not give any information about exceptional loss amounts (outside the 99% confidence interval).

Extract 18: Example of back-testing results – Extract from Societe Generale's Annual Report, page 143



Amendments to SLFRS 7

- Issued in February 2009 and applicable for annual periods beginning on or after 1 January 2009
- Covered fair value measurement and liquidity risk
- Comparative information is not required in the first year of application



Amendments to SLFRS 7: amendments to liquidity risk disclosures

- Permit derivative liabilities to be excluded from the contractual maturity analysis of financial liabilities (SLFRS7.39)
- Unless “the contractual maturities are essential for an understanding of the timing of the cash flows.”
- Requires financial guarantee contracts to be recorded in the contractual maturity analysis:
 - Based on the maximum amount guaranteed; and
 - Allocated to the earliest date they can be drawn down
- Irrespective of whether it is likely that those guarantees will be drawn or the amount that is expected to be paid



Amendments to SLFRS 7: amendments to fair value measurement disclosure

- Fair value measurements to be disclosed by the source of inputs, using the following three level hierarchy:
 - (i) Quoted prices (unadjusted) in active markets for identical assets and liabilities (Level 1)
 - (ii) Inputs other than quoted prices included in level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices) (Level 2)
 - (iii) Inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3)



Amendments to SLFRS 7: amendments to fair value measurement disclosure, cont.

- This information must be given by 'class' of financial instrument.
- This is a level lower than categories such as held for trading or available for sale.
- The three-level hierarchy disclosures are only required for financial instruments recorded at fair value.



Thank you.

