1. Objective of HKAS 32 and 39

The objective of Hong Kong Accounting Standard (HKAS) 32 *Financial Instruments: Disclosure and Presentation* is to enhance financial statement users' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows.

The objective of HKAS 39, *Financial Instruments: Recognition and Measurement* is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

2. What is Financial Instruments?

A financial instrument is any contract that gives rise to

(a) a financial asset of one entity and

(b) a financial liability or equity instrument of another entity.[2] *(HKAS 32 para. 11)*

2.1 Definition of financial asset

A financial asset is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments. *(HKAS 32 para. 11)*

[1] *This note is sourced from HKAS 32 Financial Instruments: Disclosure and Presentation and HKAS 39 Financial Instruments: Recognition and Measurement. While the note is aimed at covering all critical points of HKAS 32 and 39, a complete and comprehensive coverage should still be the original standard, HKAS 32 and 39.*

[2] *All the paragraphs in the HKAS have equal authority now. While certain paragraphs in HKAS are highlighted in bold and italic, the same format is adopted in this note for those paragraphs.*

2.2 Definition of financial liability

> ***A financial liability is any liability that is:***
>
> ***(a) a contractual obligation:***
>
> ***(i) to deliver cash or another financial asset to another entity; or***
>
> ***(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or***
>
> ***(b) a contract that will or may be settled in the entity's own equity instruments and is:***
>
> ***(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or***
>
> ***(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.*** *(HKAS 32 para. 11)*

2.3 Definition of equity instrument

> ***An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.*** *(HKAS 32 para. 11)*

2.4 Definition of derivative

Within the scope of HKAS 32 and 39, there is a specific definition on derivative as follows:

> ***A derivative is a financial instrument or other contract within the scope of HKAS 39 with all 3 of the following characteristics:***
>
> ***(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying');***
>
> ***(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and***
>
> ***(c) it is settled at a future date.*** *(HKAS 39 para. 9)*

3. Recognition and Derecognition

3.1 Initial Recognition

Initial recognition for financial assets and financial liabilities are the same. ***An entity shall recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument.*** *(HKAS 39 para. 14)*

3.1.1 Regular Way Purchase or Sale of a Financial Asset

A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting. *(HKAS 39 para. 38)*

> ***A regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.*** *(HKAS 39 para. 9)*

3.2 Derecognition of a Financial Asset

***Derecognition* is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.** *(HKAS 39 para. 9)*

Derecognition of financial assets and financial liabilities are not the same. This section sets out the derecognition of financial assets and next section (section 3.3) sets out the derecognition of financial liabilities.

In consolidated financial statements, the requirements of this section are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with HKAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation — Special Purpose Entities* and then applies the requirements of this section to the resulting group.

3.2.1 When to derecognise?

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

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

(b) it transfers the financial asset (as set out in section 3.2.2 below) and the transfer qualifies for derecognition (in accordance with section 3.2.4). *(HKAS 39 para. 17)*

3.2.2 Transfer of financial assets

An entity transfers a financial asset if, and only if, it either:

(a) transfers the contractual rights to receive the cash flows of the financial asset; or

(b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in the following section. *(HKAS 39 para. 18)*

3.2.3 Conditions of a transfer when contractual obligation to pay assumed

When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following 3 conditions are met.

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.

(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in HKAS 7* Cash Flow Statements*) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients. *(HKAS 39 para. 19)*

3.2.4 Transfer qualified for derecognition?

When an entity transfers a financial asset (see section 3.2.2 above), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

(a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset

⇒ the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

(b) if the entity retains substantially all the risks and rewards of ownership of the financial asset,

⇒ the entity shall continue to recognise the financial asset.

(c) if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset,

⇒ the entity shall determine whether it has retained control of the financial asset. In this case:

(i) if the entity has not retained control,

→ it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

(ii) if the entity has retained control,

→ it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 30). *(HKAS 39 para. 20)*

3.2.5 Gain or loss resulted from derecognition

On derecognition of a financial asset in its entirety, the difference between:

(a) the carrying amount and

(b) the sum of

(i) the consideration received (including any new asset obtained less any new liability assumed) and

(ii) any cumulative gain or loss that had been recognised directly in equity

shall be recognised in profit or loss. *(HKAS 39 para. 26)*

The gain or loss resulted from other forms of derecognition should be examined case by case.

3.3 Derecognition of a Financial Liability

An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished, i.e. when the obligation specified in the contract is discharged or cancelled or expires. *(HKAS 39 para. 39)*

An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. *(HKAS 39 para. 40)*

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss. *(HKAS 39 para. 41)*

4. Initial Measurement of Financial Assets and Financial Liabilities

When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. *(HKAS 39 para. 43)*

> ***Transaction costs*** ***are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.***
>
> ***Fair value*** ***is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.*** *(HKAS 39 para. 9)*

When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortised cost, the asset is recognised initially at its fair value on the trade date.

5. Subsequent Measurement of Financial Assets

For the purpose of measuring a financial asset after initial recognition, HKAS 39 classifies financial assets into the following 4 categories:

(a) financial assets at fair value through profit or loss;

(b) held-to-maturity investments;

(c) loans and receivables; and

(c) available-for-sale financial assets.

The above categories apply to measurement and profit or loss recognition under HKAS 39. The entity may use other descriptors for these categories or other categorisations when presenting information on the face of the financial statements. The entity shall disclose in the notes the information required by HKAS 32.

5.1 Definition of financial asset at fair value through profit or loss

> ***A financial asset (or financial liability) at fair value through profit or loss is a financial asset (or financial liability) that meets either of the following conditions.***
>
> ***(a) It is classified as held for trading. A financial asset (or financial liability) is classified as held for trading if it is:***
>
> ***(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;***
>
> ***(ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or***
>
> ***(iii) a derivative (except for a derivative that is a designated and effective hedging instrument).***
>
> ***(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. Any financial asset (or financial liability) within the scope of HKAS 39 may be designated when initially recognised as a financial asset (or financial liability) at fair value through profit or loss except for investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured.*** *(HKAS 39 para. 9)*

5.2 Definition of held-to-maturity investments

Held-to-maturity investments *are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than:*

(a) those that the entity upon initial recognition designates as at fair value through profit or loss;

(b) those that the entity designates as available for sale; and

(c) those that meet the definition of loans and receivables.

An entity shall not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications that:

(i) are so close to maturity or the financial asset's call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;

(ii) occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or

(iii) are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity. *(HKAS 39 para. 9)*

5.3 Definition of loans and receivables

Loans and receivables *are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:*

(a) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;

(b) those that the entity upon initial recognition designates as available for sale; or

(c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.

An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund is not a loan or receivable). *(HKAS 39 para. 9)*

5.4 Definition of available-for-sale financial assets

Available-for-sale financial assets *are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.* *(HKAS 39 para. 9)*

5.5 Measurement of financial assets after initial recognition

After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:

(a) loans and receivables as defined above, which shall be measured at amortised cost using the effective interest method;

(b) held-to-maturity investments as defined above, which shall be measured at amortised cost using the effective interest method; and

(c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to

and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost.

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting.

All financial assets except those measured at fair value through profit or loss are subject to review for impairment. *(HKAS 39 para. 46)*

The amortised cost of a financial asset or financial liability is

(a) the amount at which the financial asset or financial liability is measured at initial recognition

(b) minus principal repayments,

(c) plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and

(d) minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses.

The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see HKAS 18), transaction costs, and all other premiums or discounts.

There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably.

However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments). *(HKAS 39 para. 9)*

6. Subsequent Measurement of Financial Liabilities

After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:

(a) financial liabilities at fair value through profit or loss.

Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or is accounted for using the continuing involvement approach.

Continuing involvement approach

If a transfer of a financial asset does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received.

In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability.

When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability.

Despite the other measurement requirements in HKAS 39, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:

a) the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost; or

b) equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.

Financial liabilities that are designated as hedged items are subject to measurement under the hedge accounting requirements. *(HKAS 39 para. 47)*

7. Reclassifications

7.1 Reclassified into or out the fair value through profit or loss category

An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued. *(HKAS 39 para. 50)*

7.2 Reclassified from held-to-maturity to available-for-sale

If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it shall be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with HKAS 39, by recognising directly in equity. *(HKAS 39 para. 51)*

Whenever sales or reclassifications of more than an insignificant amount of held-to-maturity investments do not meet any of the conditions in its definition, any remaining held-to-maturity investments shall be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value shall be accounted for in accordance with HKAS 39, by recognising directly in equity. *(HKAS 39 para. 52)*

7.3 Reclassified from available-for-sale financial assets at cost to available-for-sale financial assets at fair value

If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available, the asset or liability shall be remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with section 8. *(HKAS 39 para. 53)*

7.3 Reclassified from available-for-sale financial assets at fair value to held-to-maturity investments or available-for-sale financial assets at cost

If, as a result of a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available or because the 'two preceding financial years' referred to in the definition of held-to-maturity investments have passed, it becomes appropriate to carry a financial asset or financial liability at cost or amortised cost rather than at fair value, the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortised cost, as applicable. Any previous gain or loss on that asset that has been recognised directly in equity shall be accounted for as follows:

(a) In the case of a financial asset with a fixed maturity, the gain or loss shall be amortised to profit or loss over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortised cost and maturity amount shall

also be amortised over the remaining life of the financial asset using the effective interest method, similar to the amortisation of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognised directly in equity is recognised in profit or loss.

(b) In the case of a financial asset that does not have a fixed maturity, the gain or loss shall remain in equity until the financial asset is sold or otherwise disposed of, when it shall be recognised in profit or loss. If the financial asset is subsequently impaired any previous gain or loss that has been recognised directly in equity is recognised in profit or loss. *(HKAS 39 para. 54)*

8. Gains and Losses

8.1 Financial instruments carried at fair value

A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship shall be recognised, as follows.

(a) A gain or loss on a financial asset or financial liability classified as at fair value through profit or loss shall be recognised in profit or loss.

(b) A gain or loss on an available-for-sale financial asset shall be recognised directly in equity, through the statement of changes in equity (see HKAS 1* Presentation of Financial Statements*), except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in profit or loss.

However, interest calculated using the effective interest method is recognised in profit or loss (see HKAS 18* Revenue*).

Dividends on an available-for-sale equity instrument are recognised in profit or loss when the entity's right to receive payment is established (see HKAS 18). *(HKAS 39 para. 55)*

8.2 Financial instruments carried at amortised cost

For financial assets and financial liabilities carried at amortised cost, a gain or loss is recognised in profit or loss when the financial asset or financial liability is derecognised or impaired, and through the amortisation process. However, for financial assets or financial liabilities that are hedged items the accounting for the gain or loss shall follow hedge accounting. *(HKAS 39 para. 56)*

8.3 Financial assets using settlement date accounting

If an entity recognises financial assets using settlement date accounting, any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets carried at cost or amortised cost (other than impairment losses). For assets carried at fair value, however, the change in fair value shall be recognised in profit or loss or in equity, as appropriate under section 8.1 above. *(HKAS 39 para. 57)*

9. Impairment and Uncollectibility of Financial Assets

An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. *(HKAS 39 para. 58)*

9.1 Financial Assets Carried at Amortised Cost

If there is objective evidence that an impairment loss on <u>loans and receivables</u> or <u>held-to-maturity investments</u> carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The

carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss. *(HKAS 39 para. 63)*

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss shall be reversed either directly or by adjusting an allowance account.

The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal shall be recognised in profit or loss. *(HKAS 39 para. 65)*

9.2 Financial Assets Carried at Cost

If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

Such impairment losses shall not be reversed. *(HKAS 39 para. 66)*

9.3 Available-for-Sale Financial Assets

When a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognised directly in equity shall be removed from equity and recognised in profit or loss even though the financial asset has not been derecognised. *(HKAS 39 para. 67)*

The amount of the cumulative loss that is removed from equity and recognised in profit or loss shall be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in profit or loss. *(HKAS 39 para. 68)*

Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale shall not be reversed through profit or loss. *(HKAS 39 para. 69)*

If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss shall be reversed, with the amount of the reversal recognised in profit or loss. *(HKAS 39 para. 70)*

10. Embedded Derivatives

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

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

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

An embedded derivative shall be separated from the host contract and accounted for as a derivative under HKAS 39 if, and only if:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

If an embedded derivative is separated, the host contract shall be accounted for under HKAS 39 if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument. HKAS 39 does not address whether an embedded derivative shall be presented separately on the face of the financial statements. *(HKAS 39 para. 11)*

If an entity is required by HKAS 39 to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it shall treat the entire combined contract as a financial asset or financial liability that is held for trading. *(HKAS 39 para. 12)*

If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid instrument and the fair value of the host contract, if those can be determined under HKAS 39. If the entity is unable to determine the fair value of the embedded derivative using this method, the above paragraph applies and the combined instrument is treated as held for trading.

11. Presentation

11.1 Liabilities vs. Equity

The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument. *(HKAS 32 para. 15)*

When an issuer applies the definitions of financial instruments to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

11.1.1 No Contractual Obligation to Deliver Cash or Another Financial Asset

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either

to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.

Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party.

The substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example:

(a) a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

(b) a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability.

If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. For example:

(a) a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

(b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:

(a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.

(b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:

  (i) cash or another financial asset; or

  (ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option.

11.1.2 Settlement in the Entity's Own Equity Instruments

A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation.

Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's

own equity instruments (e.g. an interest rate, a commodity price or a financial instrument price). 2 examples are:

(a) a contract to deliver as many of the entity's own equity instruments as are equal in value to $100, and

(b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 ounces of gold.

Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument.

A contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash.

A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. An example is a contract for the entity to deliver 100 of its own equity instruments in return for an amount of cash calculated to equal the value of 100 ounces of gold.

11.1.3 Contingent Settlement Provisions

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, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio.

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 unless:

(a) the 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

(b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

11.1.4 Settlement Options

When a derivative financial instrument gives one party a choice over how it is settled (e.g. 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. *(HKAS 32 para. 26)*

An example of a derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash. Similarly, some contracts to buy or sell a non-financial item in exchange

for the entity's own equity instruments are within the scope of HKAS 32 because they can be settled either by delivery of the non-financial item or net in cash or another financial instrument. Such contracts are financial assets or financial liabilities and not equity instruments.

11.2 Compound Financial Instruments

The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15 of HKAS 32 (see section 11.1 above). *(HKAS 32 para. 28)*

An entity recognises separately the components of a financial instrument that

(a) creates a financial liability of the entity and

(b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity.

For example, a bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the entity is a compound financial instrument. From the perspective of the entity, such an instrument comprises 2 components:

(a) a financial liability (a contractual arrangement to deliver cash or another financial asset) and

(b) an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity).

The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase ordinary shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the entity presents the liability and equity components separately on its balance sheet.

Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders.

11.2.1 Allocation between the liability component and equity component

Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component.

The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognising the components of the instrument separately.

Under the above approach, the issuer of a bond convertible into ordinary shares first determines the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component. The carrying amount of the equity instrument represented by the option to convert the instrument into ordinary shares is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

11.3 Treasury Shares

If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired

and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity. *(HKAS 32 para. 33)*

The amount of treasury shares held is disclosed separately either on the face of the balance sheet or in the notes, in accordance with HKAS 1 *Presentation of Financial Statements*. An entity provides disclosure in accordance with HKAS 24 *Related Party Disclosures* if the entity reacquires its own equity instruments from related parties.

11.4 Interest, Dividends, Losses and Gains

Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.

Distributions to holders of an equity instrument shall be debited by the entity directly to equity, net of any related income tax benefit.

Transaction costs of an equity transaction, other than costs of issuing an equity instrument that are directly attributable to the acquisition of a business (which shall be accounted for under HKAS 22), shall be accounted for as a deduction from equity, net of any related income tax benefit. *(HKAS 32 para. 35)*

11.5 Offsetting a Financial Asset and a Financial Liability

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

(a) currently has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see HKAS 39, paragraph 36). *(HKAS 32 para. 42)*

12. Disclosure

The purpose of the disclosures required by HKAS 32 is to provide information to enhance understanding of the significance of financial instruments to an entity's financial position, performance and cash flows, and assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments.

Transactions in financial instruments may result in an entity assuming or transferring to another party one or more of the financial risks described below. The required disclosures provide information to assist users of financial statements in assessing the extent of risk related to financial instruments.

(a) Market risk includes 3 types of risk:

(i) currency risk — the risk that the value of a financial instrument will fluctuate because of changes in foreign exchange rates.

(ii) fair value interest rate risk — the risk that the value of a financial instrument will fluctuate because of changes in market interest rates.

(iii) price risk — the risk that the value of a financial instrument will fluctuate as a result of changes in market prices, whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all instruments traded in the market. Market risk embodies not only the potential for loss but also the potential for gain.

(b) Credit risk — the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

(c) Liquidity risk (also referred to as funding risk) — the risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments. Liquidity risk may result from an inability to sell a financial asset quickly at close to its fair value.

(d) Cash flow interest rate risk—the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates. In the case of a floating rate debt instrument, for example, such fluctuations result in a change in the effective interest rate of the financial instrument, usually without a corresponding change in its fair value.

12.1 Risk Management Policies and Hedging Activities

An entity shall describe its financial risk management objectives and policies, including its policy for hedging each main type of forecast transaction for which hedge accounting is used. *(HKAS 32 para. 56)*

An entity shall disclose the following separately for designated fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation (as defined in HKAS 39):

(a) a description of the hedge;

(b) a description of the financial instruments designated as hedging instruments and their fair values at the balance sheet date;

(c) the nature of the risks being hedged; and

(d) for cash flow hedges, the periods in which the cash flows are expected to occur, when they are expected to enter into the determination of profit or loss, and a description of any forecast transaction for which hedge accounting had previously been used but which is no longer expected to occur. *(HKAS 32 para. 58)*

When a gain or loss on a hedging instrument in a cash flow hedge has been recognised directly in equity, through the statement of changes in equity, an entity shall disclose:

(a) the amount that was so recognised in equity during the period;

(b) the amount that was removed from equity and included in profit or loss for the period; and

(c) the amount that was removed from equity during the period and included in the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non-financial liability in a hedged highly probable forecast transaction. *(HKAS 32 para. 59)*

12.2 Terms, Conditions and Accounting Policies

For each class of financial asset, financial liability and equity instrument, an entity shall disclose:

(a) information about the extent and nature of the financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows; and

(b) the accounting policies and methods adopted, including the criteria for recognition and the basis of measurement applied. *(HKAS 32 para. 60)*

As part of the disclosure of an entity's accounting policies, an entity shall disclose, for each category of financial assets, whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see HKAS 39, paragraph 38). *(HKAS 32 para. 61)*

12.3 Interest Rate Risk

For each class of financial assets and financial liabilities, an entity shall disclose information about its exposure to interest rate risk, including:

(a) contractual repricing or maturity dates, whichever dates are earlier; and

(b) effective interest rates, when applicable. *(HKAS 32 para. 67)*

12.4 Credit Risk

For each class of financial assets and other credit exposures, an entity shall disclose information about its exposure to credit risk, including:

(a) the amount that best represents its maximum credit risk exposure at the balance sheet date, without taking account of the fair value of any collateral, in the event of other parties failing to perform their obligations under financial instruments; and

(b) significant concentrations of credit risk. *(HKAS 32 para. 76)*

12.5 Fair Value

Except as set out in paragraph 90, for each class of financial assets and financial liabilities, an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with the corresponding carrying amount in the balance sheet. (HKAS 39 provides guidance for determining fair value.) *(HKAS 32 para. 86)*

If investments in unquoted equity instruments or derivatives linked to such equity instruments are measured at cost under HKAS 39 because their fair value cannot be measured reliably, that fact shall be disclosed together with a description of the financial instruments, their carrying amount, an explanation of why fair value cannot be measured reliably and, if possible, the range of estimates within which fair value is highly likely to lie. Furthermore, if financial assets whose fair value previously could not be reliably measured are sold, that fact, the carrying amount of such financial assets at the time of sale and the amount of gain or loss recognised shall be disclosed. *(HKAS 32 para. 90)*

An entity shall disclose:

(a) the methods and significant assumptions applied in determining fair values of financial assets and financial liabilities separately for significant classes of financial assets and financial liabilities. (Paragraph 55 provides guidance for determining classes of financial assets.)

(b) whether fair values of financial assets and financial liabilities are determined directly, in full or in part, by reference to published price quotations in an active market or are estimated using a valuation technique (see HKAS 39, paragraphs AG71-AG79).

(c) whether its financial statements include financial instruments measured at fair values that are determined in full or in part using a valuation technique based on assumptions that are not supported by observable market prices or rates. If changing any such assumption to a reasonably possible alternative would result in a significantly different fair value, the entity shall state this fact and disclose the effect on the fair value of a range of reasonably possible alternative assumptions. For this purpose, significance shall be judged with respect to profit or loss and total assets or total liabilities.

(d) the total amount of the change in fair value estimated using a valuation technique that was recognised in profit or loss during the period. *(HKAS 32 para. 92)*

12.6 Other Disclosures

12.6.1 Derecognition

(a) An entity may have either transferred a financial asset (see paragraph 18 of HKAS 39) or entered into the type of arrangement described in paragraph 19 of HKAS 39 in such a way that the arrangement does not qualify as a transfer of a financial asset. If the entity either continues to recognise all of the asset or continues to recognise the asset to the extent of the entity's continuing involvement (see HKAS 39, paragraphs 29 and 30) it shall disclose for each class of financial asset:

(i) the nature of the assets;

(ii) the nature of the risks and rewards of ownership to which the entity remains exposed;

(iii) when the entity continues to recognise all of the asset, the carrying amounts of the asset and of the associated liability; and

(iv) when the entity continues to recognise the asset to the extent of its continuing involvement, the total amount of the asset, the amount of the asset that the entity continues to recognise and the carrying amount of the associated liability.

12.6.2 Collateral

(b) An entity shall disclose the carrying amount of financial assets pledged as collateral for liabilities, the carrying amount of financial assets pledged as collateral for contingent liabilities, and any material terms and conditions relating to assets pledged as collateral.

(c) When an entity has accepted collateral that it is permitted to sell or repledge in the absence of default by the owner of the collateral, it shall disclose:

(i) the fair value of the collateral accepted (financial and non-financial assets);

(ii) the fair value of any such collateral sold or repledged and whether the entity has an obligation to return it; and

(iii) any material terms and conditions associated with its use of this.

12.6.3 Compound financial instruments with multiple embedded derivatives

(d) If an entity has issued an instrument that contains both a liability and an equity component and the instrument has multiple embedded derivative features whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features and the effective interest rate on the liability component (excluding any embedded derivatives that are accounted for separately).

12.6.4 Financial assets and financial liabilities at fair value through profit or loss

(e) An entity shall disclose the carrying amounts of financial assets and financial liabilities that:

(i) are classified as held for trading; and

(ii) were, upon initial recognition, designated by the entity as financial assets and financial liabilities at fair value through profit or loss (i.e. those that are not financial instruments classified as held for trading).

(f) If the entity has designated a financial liability as at fair value through profit or loss, it shall disclose:

(i) the amount of change in its fair value that is not attributable to changes in a benchmark interest rate (e.g. LIBOR); and

(ii) the difference between its carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

12.6.5 Reclassification

(g) If the entity has reclassified a financial asset as one measured at cost or amortised cost rather than at fair value (see HKAS 39, paragraph 54), it shall disclose the reason for that reclassification.

12.6.6 Income statement and equity

(h) An entity shall disclose material items of income, expense and gains and losses resulting from financial assets and financial liabilities, whether included in profit or loss or as a separate component of equity. For this purpose, the disclosure shall include at least the following items:

(i) total interest income and total interest expense (calculated using the effective interest method) for financial assets and financial liabilities that are not at fair value through profit or loss;

(ii) for available-for-sale financial assets, the amount of any gain or loss recognised directly in equity during the period and the amount that was removed from equity and recognised in profit or loss for the period; and

(iii) the amount of interest income accrued on impaired financial assets.

12.6.7 Impairment

(i) An entity shall disclose the nature and amount of any impairment loss recognised in profit or loss for a financial asset, separately for each significant class of financial asset.

12.6.8 Defaults and breaches

(j) With respect to any defaults of principal, interest, sinking fund or redemption provisions during the period on loans payable recognised as at the balance sheet date, and any other breaches during the period of loan agreements when those breaches can permit the lender to demand repayment (except for breaches that are remedied, or in response to which the terms of the loan are renegotiated, on or before the balance sheet date), an entity shall disclose:

(i) details of those breaches;

(ii) the amount recognised as at the balance sheet date in respect of the loans payable on which the breaches occurred; and

(iii) with respect to amounts disclosed under (ii), whether the default has been remedied or the terms of the loans payable renegotiated before the date the financial statements were authorised for issue. *(HKAS 32 para. 94)*