

HKFRS News

February 2008

In this newsletter...

1. HKFRS 7 – Frequently Asked Questions
2. Contacts

HKFRS 7 – Frequently Asked Questions

These frequently asked questions (FAQs) are relating to of the application of HKFRS 7 *Financial Instruments: Disclosures*. These follow on from the first set of HKFRS 7 FAQs published in the HKFRS News of November 2006.

Scope

Q1. Are accruals included in the scope of HKFRS 7?

It depends. Some accruals represent a right to receive cash or an obligation to deliver cash and are included in the scope of HKFRS 7. An example is an accrual for services obtained but for which an invoice has not been received.

A prepaid expense, for example, a prepaid rent or prepaid insurance premium, or an advance payment received is not a financial instrument and is excluded from the scope of HKFRS 7.

Q2. Are provisions included in the scope of HKFRS 7?

No. Provisions that meet the definition of HKAS 37.10 'a liability of uncertain timing or amount' are scoped out of HKFRS 7 [HKAS 37.2 and HKFRS 7.3-4 in combination with HKAS 39.2(j)]. Financial guarantee contracts that are measured in accordance with HKAS 37 are nevertheless financial instruments that fall within the scope of HKFRS 7.

Fair value disclosures

Q3. HKFRS 7.9(c) states that:

'If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss ("FVTPL"), it shall disclose:

- (c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:
 - (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or



HKFRS has converged with IFRS effective from 1 January 2005. Contents contained in this newsletter are relevant to both HKFRS preparers and IFRS preparers.

© 2008 PricewaterhouseCoopers. All rights reserved.

- (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.⁷

Would we expect this to apply to all assets that are measured at FVTPL, or is it limited to loans and receivables that are designated at FVTPL? For example, would this paragraph apply to listed bonds?

Only loans and receivables that were designated at FVTPL are included in this disclosure required by HKFRS 7.9(c).

Listed bonds are not classified as loans and receivables in accordance with HKAS 39.9, as they are quoted. Therefore, they do not need to be disclosed under HKFRS 7.9(c) above.

Defaults and breaches

Q4. An entity systematically pays its short-term accounts payable (contractually due in 60 days) after the contractually due date (to finance its business). Does the entity include these trade payables in the disclosure required of defaults and breaches on loans payable required by HKFRS 7.18-19?

No. Based on the definition of loans payable in Appendix A, short-term payables are not loans payable and are therefore excluded from the disclosures of defaults and breaches required by HKFRS 7.18-19.



Hedge accounting disclosures

Q5. HKFRS 7 applies to financial assets and financial liabilities that are within the scope of HKAS 39 [HKFRS 7.4].

When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability in terms of HKAS 39 [HKAS 39.93].

HKFRS 7 defines credit risk as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. Liquidity risk is defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities [HKFRS 7, Appendix A].

Does a firm commitment asset or liability expose the entity to credit and/or liquidity risk?

No. A firm commitment to acquire a non-financial asset or liability does not meet the definition of a financial asset or financial liability and is therefore outside the scope of HKFRS 7. The asset or liability resulting from the application of hedge accounting simply measures the cumulative exposure of the entity to the hedged risk. However, a firm commitment to acquire a financial asset or liability is itself a financial instrument and falls within the scope of HKFRS 7.

Risk disclosures

Q6. How does an entity with two distinct operations, for example, a retail division and a bank division, present the minimum risk disclosures required by HKFRS 7.34(b) and HKFRS 7.36-42?

An entity with two distinct divisions is permitted to provide the minimum disclosures on a consolidated basis for the bank and the retail business. HKFRS 7 disclosures are normally provided on a consolidated basis in accordance with HKAS 27.22, unless there is a specific exception (such as for those disclosures that are based on management's reporting).

Alternatively the entity can choose to provide the minimum disclosures separately for the bank and the retail business to reflect the way management monitors the financial risks. However, if there were material transactions between the businesses, separate disclosure may be misleading.

Q7. Does an entity restate the comparative risk disclosures for changes in volatility? For example, the reasonable possible change in an exchange rate from 5% in the prior year to 8% in the current year?

No. The prior-year disclosures are not restated if volatility (and therefore the range for a reasonable change) increases or decreases between two balance sheet dates.

Q8. Entity Y is producing seeds for the agricultural industry. The main season for planting the seed is spring. 75% of Y's markets are in the northern hemisphere; 25% are in the southern hemisphere. Entity Y's account receivables are approximately £400 million in June and £100 million in December. Entity Y has a December year end. Does Y have to disclose additional information about its exposure to credit risk on the receivables that is representative of its exposure to risk during the year (HKFRS 7.35)?

Yes. The December year-end exposure to credit risk is unrepresentative of the entity's exposure during the period. Entity Y should provide further information that is representative, such as a description (with amounts) of how the exposures vary during the year, or the average (or highest) exposure to credit risk during the year.

Credit risk

Q9. HKFRS 7.37(b) states that disclosure includes an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired.

Consider a situation where an entity has £300m of receivables where this amount is categorised into:

- i. £100m of the receivables that have been assessed individually for impairment and based on the conditions stated in HKAS 39. 58-61 are concluded to be impaired;

- ii. £100m of a collection of insignificant receivables that are individually concluded to be impaired on the basis of the HKAS 39 but the impairment calculation is carried out on the £100m amount for efficiency purposes; and

- iii. £100m of a portfolio of assets for which there is observable data indicating that there is a measurable decrease in the estimated future cash flows from that group of financial assets, although the decrease cannot be identified with individual financial assets [HKAS 39.59(f)].

Of these three categories, which require disclosure under HKFRS 7.37(b)?

Both categories (i) and (ii) require disclosure under HKFRS 7.37(b); in these categories the assets are individually assessed for impairment.

The disclosure is not required for category (iii); in this category the assets are assessed on a portfolio basis rather than an individual basis. However, actual impairment loss on the portfolio of assets is disclosed for income statement purposes under HKFRS 7.20(e): 'An entity shall disclose the amount of any impairment loss for each class of financial assets either on the face of the income statement or in the notes'.

Liquidity risk – maturity analysis

Q10. If gross cash flows are exchanged under a derivative contract, does HKFRS 7 require disclosure of the gross cash flows, even if the exchange occurs simultaneously?

Yes. HKFRS 7 B14(d) is clear that contractual amounts exchanged in a derivative financial instrument (for example, a currency swap) are disclosed on a gross basis if gross cash flows are exchanged. This is the case even if the cash flows are exchanged simultaneously.

Q11. Are financial guarantees (in the scope of HKAS 39 and therefore also in the scope of HKFRS 7) included in the maturity analysis? If so, in which time band is the financial guarantee included in the maturity analysis?

No. At the balance sheet date, the counterparty does not have a right to demand cash; there is therefore no time bucket to which the cash flow can be attributed.

This is because HKFRS 7 B12 states that when a counterparty has a choice of when an amount is paid, the liability is included on the basis of the earliest period in which the entity can be required to pay. However, at the balance sheet date, the counterparty does not have the right to demand cash, as the default has not occurred.

HKFRS 7 B16 states that when the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at balance sheet date. Because the counterparty has no right to demand cash during the pre-default period, HKFRS 7 B16 is not relevant.

Q12. How is a written put option treated in the maturity analysis?

It depends on whether the option is settled net or gross and whether the option is in our out of the money at the balance sheet date.

If the option is out of the money and net settled, no liability is required to be disclosed in the maturity table, because there is no obligation to make a payment based on the conditions existing at the balance sheet date (HKFRS 7 B16).

For gross settled derivatives where the counterparty can force the issuer to make a payment, the pay leg is disclosed in the liquidity table in the earliest time bucket irrespective of whether the instrument is in or out of the money.

An American style option is disclosed in the earliest time band; a European-style option is disclosed depending on the exercise date.

Q13. A company monitors and manages liquidity risk using cash flow forecasts including forecasts of revenue, operating cash outflows and financing items. Does HKFRS 7 require the entity to disclose those cash flow forecasts?

No. Although HKFRS 7.33, 7.34 and 7.39 require an entity to provide both qualitative and quantitative information about its exposure to a particular risk, the standard only requires qualitative information about how it manages that risk.

The information contained in a cash flow forecast relating to cash inflows from revenues, sales of assets and new financings, and about cash outflows from operations

and sources other than financial liabilities represents information that management uses to manage the liquidity risk as defined in HKFRS 7 (the cash outflows associated with financial liabilities). Accordingly, this will be disclosed by way of qualitative information. This might take the form of a disclosure that regular cash flow forecasts are prepared and reviewed by management, together with the other factors management used to manage liquidity risk (which might include some or all of the factors listed in IG31).

Q14. Bank A gives entity B Ltd a credit facility of £3m at the rate of 7% on 1 January. B Ltd has to repay any amounts drawn under the facility in five years time and pays quarterly interest. On 31 December, B Ltd has drawn down £1m.

What amounts should be included in the maturity analysis in respect of the above facility by:

(i) Bank A; and

Bank A should include the undrawn amount (£2m) of the credit facility in the earliest period in which the B Ltd is be able to draw it [HKFRS 7 B13]. The bank could choose to show the liquidity risks arising from off-balance sheet items in a separate table.

HKFRS 7 B16 is not relevant, because the amount that the counterparty can require to be paid in cash is fixed.



(ii) Entity B Ltd?

B Ltd should include the drawn amount of £1m in a time band of five years reflect when repayment is contractually due. B should also disclose the interest payments on the debt over the same five-year period. The undrawn amount of £2m does not represent a future cash outflow and is therefore not included in the maturity analysis.

Additional details of the undrawn facilities and any restrictions on them are recommended disclosure under HKAS 7.50(a).

Market risk – sensitivity analysis

Q15. An entity uses highly effective cash flow hedges to hedge the foreign currency risk of future sales in a foreign currency. How does the entity reflect the effect of the hedge on profit or loss and equity in the sensitivity analysis (HKFRS 7.40(a))?

The fair value movement related to the effective part of the hedging instrument is included in equity. Ineffectiveness is reflected in profit or loss.

Movements on the foreign exchange risk exposure on the future sales are not included in the sensitivity analysis, as they were not recognised financial assets or financial liabilities at the balance sheet date.

Q16. An entity is required to show in a sensitivity analysis the impact of a reasonably possible shift in market risks on profit or loss and equity. Does an entity that has available-for-sale (AFS) equity investments take into consideration its impairment policy to distinguish between impacts on equity (if a reasonably possible decrease in share prices results in an amount below the impairment threshold) and impacts on profit or loss (if a reasonably possible decrease in share prices results in an amount above the impairment threshold)?

Yes. In cases where the fair value of a non-monetary AFS instrument is close to the impairment threshold, the entity distinguishes between profit or loss and equity effects, taking into consideration its impairment policy.

In cases where a non-monetary AFS financial asset is already impaired, the downwards shift is shown as affecting profit or loss; the upwards shift is shown affecting equity.

Q17. An entity uses a value-at-risk (VaR) model for managing its currency exposures (interdependencies are reflected). However, outstanding inter-company foreign currency receivables and payables at year-end are not considered in the VaR model. Does the entity prepare additional disclosures for the currency risk on inter-company transactions?

Yes, the entity prepares additional sensitivity disclosures for the outstanding inter-company foreign currency receivables and payables, as changes in exchange rates will have an effect on profit or loss arising from these balances.

Q18. HKFRS 7.40 requires an entity to disclose the effect on net income and equity of reasonably possible changes in market prices.

Certain entities are exposed to changes in their own stock price – for example, entities that have issued warrants with a foreign currency exercise price that are classified as derivative liabilities or entities that have



issued convertible debt that fails the fixed-to-fixed requirement in HKAS 32. In other cases, entities may have issued share-based compensation awards that are classified as liabilities.

Where an entity's net income is affected by changes in its own share price, does it disclose the effect on net income of reasonably possible changes in its share price on:

a) financial instruments that it issued which are within the scope of HKAS 39?

Yes, an entity discloses information about the effect of reasonably possible changes in its share price on its net income, because instruments within the scope of HKAS 39 are generally within the scope of HKFRS 7, and because changes in the market value of the entity's own stock meet the definition of an 'other price risk'. The effect on net income of reasonably possible changes in an entity's own share price (if any) is therefore disclosed. The same might be true for financial instruments other than shares – for example, derivatives on own shares or an entity's debt instrument, if they are classified as at FVTPL.

b) share-based payment awards with the scope of HKFRS 2?

No, instruments within the scope of HKFRS 2 (and not within the scope of HKAS 39) are scoped out by HKFRS 7.3(e).

Q19. An entity uses for own risk management purposes a 10-day VaR. Management believes that this 10-day VaR satisfies the requirements of HKFRS7.41 and does not prepare an additional disclosure based on HKFRS 7.40. Do you agree with management?

Yes. HKFRS 7 B20 is clear that the method used by management does not need to reflect the total income statement impact ('this applies even if such a methodology measures only the potential loss and does not measure the potential gain'). In addition, BC61 explains that the Board decided not to require disclosure on the effects on profit or loss and equity if an alternative disclosure of sensitivity is made.

Other disclosure issues

Q20. A subsidiary prepares stand-alone HKFRS financial statements, but the financial risk management is carried out centrally by the parent. The parent prepares a VaR analysis for the entire group. Does the subsidiary still need to prepare the market risk sensitivity analysis as required by HKFRS 7.40?

Yes. The subsidiary should comply with the minimum disclosure requirements in its stand-alone financial statements.

Contacts

For further help, please contact:

Hong Kong

22/F Prince's Building
Central, Hong Kong
Tel: +852 2289 8888

Beijing

26/F Office Tower A
Beijing Fortune Plaza
7 Dongsanhuan Zhong Road
Chaoyang District
Beijing 100020, PRC
Tel: +86 (10) 6533 8888

Shanghai

11/F PricewaterhouseCoopers Center
202 Hu Bin Road
Shanghai 200021, PRC
Tel: +86 (21) 6123 8888

Chongqing

Room 1905
19/F Metropolitan Tower
68 Zou Rong Road
Chongqing 400010, PRC
Tel: +86 (23) 6393 7888

Dalian

8/F Senmao Building
147 Zhongshan Road
Xigang District
Dalian 116011, PRC
Tel: +86 (411) 8379 1888

Guangzhou

25/F Center Plaza
161 Lin He Xi Road
Guangzhou 510620, PRC
Tel: +86 (20) 3819 2000

Macau

28/F Unit C
Bank of China Building
Avenida Doutor Mario Soares
Macau
Tel: +853 8799 5111

Qingdao

4601 Qingdao International Finance Center
59 Hong Kong Middle Road
Qingdao 266071, PRC
Tel: +86 (532) 8089 1888

Shenzhen

38/F Shun Hing Square
Di Wang Commercial Centre
5002 Shennan Road East
Shenzhen 518008, PRC
Tel: +86 (755) 8261 8888

Suzhou

Room 1501
Genway Tower
188 Wang Dun Road
Suzhou Industrial Park
Suzhou 215028, PRC
Tel: +86 (512) 6273 1888

Tianjin

17/F The Exchange Tower One
189 Nanjing Road, Heping District
Tianjin 300051, PRC
Tel: +86 (22) 2330 6789

Xi'an

Room 728
Zhongda International Mansion
30 Nan Da Street
Xi'an 710002, PRC
Tel: +86 (29) 8720 3336

<http://www.pwchk.com>
<http://www.pwc.com/ifrs>

