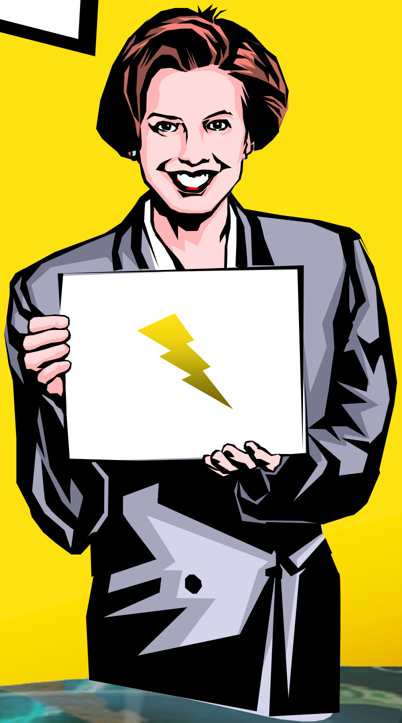
PAS 39

Financial Instruments:

Recognition & Measurement

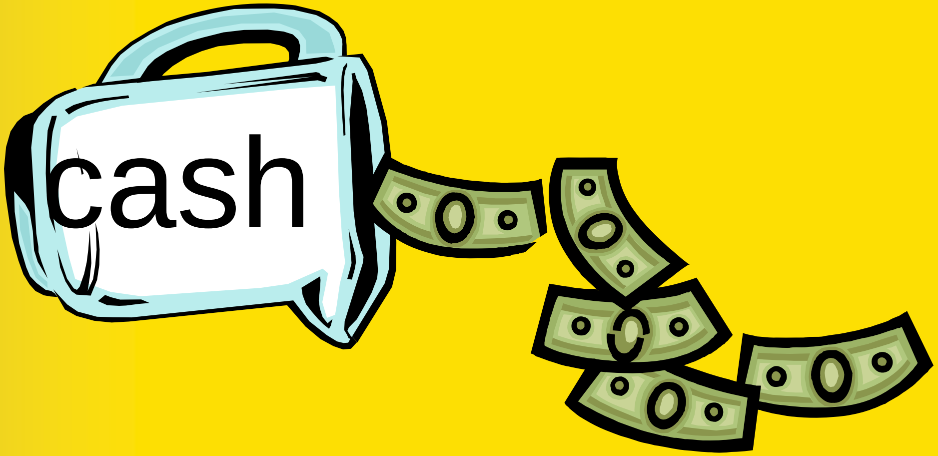
Definitions [PAS 39.9]

<u>Financial instrument</u>: A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.



Financial Asset

Any asset that is:

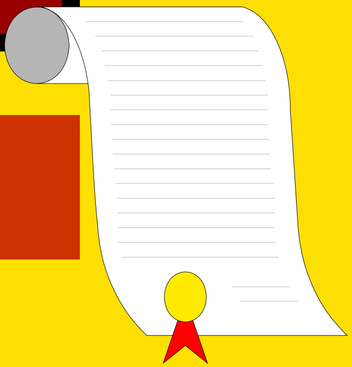


Financial Asset

Any asset that is:

- an equity instrument of another entity;

Financial Asset



Any asset that is:

- a contractual right:
  - to receive cash or another financial asset from another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

Financial Asset

Any asset that is:

- 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 receive 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.

Financial liability

Any liability that is:

a contractual obligation:

- to deliver cash or another financial asset to another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments

Common Example of Financial Instruments

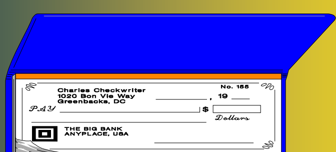
Cash

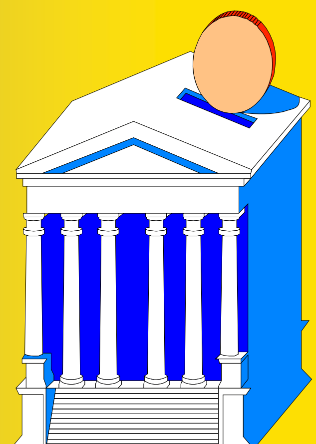
Common Examples of Financial Instruments

Demand and time deposits

Commercial paper

Accounts, notes, and loans receivable and payable





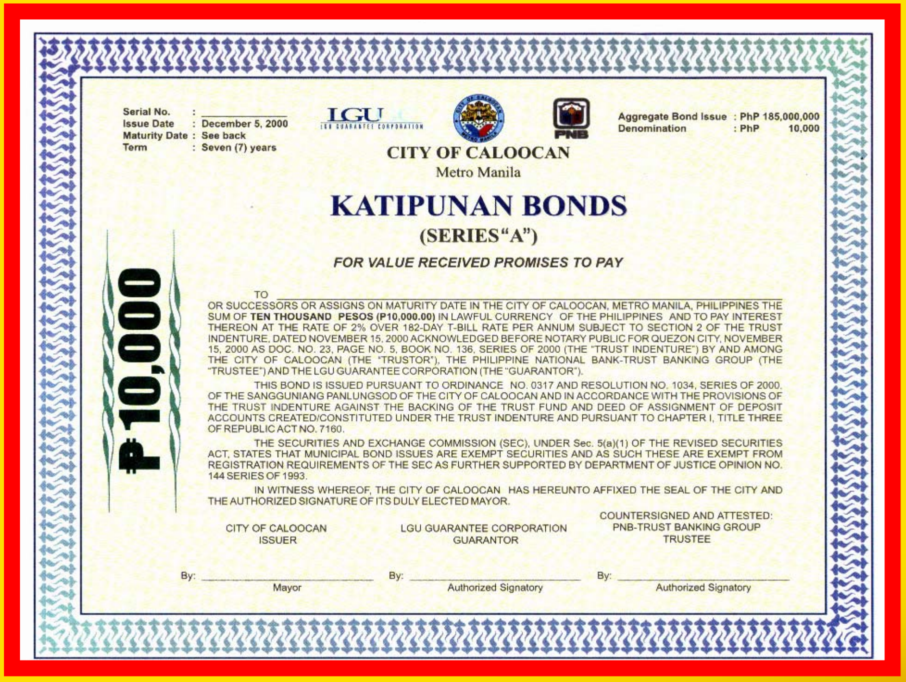
Demand Deposits

Time Deposits & Money Market Accts.

=

Common Examples of Financial Instruments

Debt securities



Serial No. :
Issue Date : December 5, 2000
Maturity Date : See back
Term : Seven (7) years

Aggregate Bond Issue : PhP 185,000,000
Denomination : PhP 10,000

CITY OF CALOOCAN
Metro Manila

KATIPUNAN BONDS
(SERIES "A")

FOR VALUE RECEIVED PROMISES TO PAY

₱10,000

TO ______________________
OR SUCCESSORS OR ASSIGNS ON MATURITY DATE IN THE CITY OF CALOOCAN, METRO MANILA, PHILIPPINES THE SUM OF **TEN THOUSAND PESOS (P10,000.00)** IN LAWFUL CURRENCY OF THE PHILIPPINES AND TO PAY INTEREST THEREON AT THE RATE OF 2% OVER 182-DAY T-BILL RATE PER ANNUM SUBJECT TO SECTION 2 OF THE TRUST INDENTURE, DATED NOVEMBER 15, 2000 ACKNOWLEDGED BEFORE NOTARY PUBLIC FOR QUEZON CITY, NOVEMBER 15, 2000 AS DOC. NO. 23, PAGE NO. 5, BOOK NO. 136, SERIES OF 2000 (THE "TRUST INDENTURE") BY AND AMONG THE CITY OF CALOOCAN (THE "TRUSTOR"), THE PHILIPPINE NATIONAL BANK-TRUST BANKING GROUP (THE "TRUSTEE") AND THE LGU GUARANTEE CORPORATION (THE "GUARANTOR").

THIS BOND IS ISSUED PURSUANT TO ORDINANCE NO. 0317 AND RESOLUTION NO. 1034, SERIES OF 2000, OF THE SANGGUNIANG PANLUNGSOD OF THE CITY OF CALOOCAN AND IN ACCORDANCE WITH THE PROVISIONS OF THE TRUST INDENTURE AGAINST THE BACKING OF THE TRUST FUND AND DEED OF ASSIGNMENT OF DEPOSIT ACCOUNTS CREATED/CONSTITUTED UNDER THE TRUST INDENTURE AND PURSUANT TO CHAPTER I, TITLE THREE OF REPUBLIC ACT NO. 7160.

THE SECURITIES AND EXCHANGE COMMISSION (SEC), UNDER Sec. 5(a)(1) OF THE REVISED SECURITIES ACT, STATES THAT MUNICIPAL BOND ISSUES ARE EXEMPT SECURITIES AND AS SUCH THESE ARE EXEMPT FROM REGISTRATION REQUIREMENTS OF THE SEC AS FURTHER SUPPORTED BY DEPARTMENT OF JUSTICE OPINION NO. 144 SERIES OF 1993.

IN WITNESS WHEREOF, THE CITY OF CALOOCAN HAS HEREUNTO AFFIXED THE SEAL OF THE CITY AND THE AUTHORIZED SIGNATURE OF ITS DULY ELECTED MAYOR.

CITY OF CALOOCAN ISSUER	LGU GUARANTEE CORPORATION GUARANTOR	COUNTERSIGNED AND ATTESTED: PNB-TRUST BANKING GROUP TRUSTEE
By: ______________ Mayor	By: ______________ Authorized Signatory	By: ______________ Authorized Signatory

Common Examples of Financial Instruments

Equity Securities

Common Examples of Financial Instruments

- Asset backed securities
  - collateralized mortgage obligations,
  - repurchase agreements, and securitized packages of receivables
- Derivatives, including
  - options,
  - rights,
  - warrants,
  - futures contracts,
  - forward contracts, and
  - swaps.
- Leases Rights and obligations with insurance risk under insurance contracts
- Employers' rights and obligations under pension contracts

Equity Securities

- financial instruments from the perspectives of both the holder and the issuer.
  - investments in subsidiaries,
  - Investment in associates, and
  - Interests in joint ventures

DERIVATIVE

It is a financial instrument whose value changes in response to the change in an underlying variable such as an interest rate, commodity or security price, or index;

- requires no initial investment, or one that is smaller than would be required for a contract with similar response to changes in market factors; and
- **settled at a future date.**

Forward

Contracts to purchase or sell a specific quantity of

- a financial instrument,
- a commodity, or
- a foreign currency

at a specified price determined at the outset,

with delivery or settlement at a specified future date.

Settlement is at maturity by actual delivery of the item specified in the contract, or by a

net cash settlement.

Interest Rate Swaps & Forward Rate Agreements

Contracts to exchange cash flows as of a specified date or a series of specified dates based on a notional amount and fixed and floating rates.

Futures

Contracts similar to forwards but with the following differences.

Next slide please .

FUTURES	FORWARDS
exchange-traded	individually tailored
settled through an offsetting (reversing) trade	settled by delivery of the underlying item or cash settlement.

Options

CALL OPTION

Contracts that give a person the right, but not the obligation, to buy

PUT OPTION

Contracts that give a person the right, but not the obligation, to sell (put option)

a specified quantity of a particular financial instrument, commodity, or foreign currency, at a specified price (strike price), during or at a specified period of time.

Options

The purchaser of the option pays the seller (writer) of the option a fee (premium) to compensate the seller for the risk of payments under the option.

Caps & Floors

Also called interest rate options. An interest rate cap will compensate the purchaser of the cap if interest rates rise above a predetermined rate (strike rate) while an interest rate floor will compensate the purchaser if rates fall below a predetermined rate.

Embedded Derivatives

Some contracts that by themselves are not financial instruments may nonetheless have financial instruments embedded in them.

Embedded Derivatives

For example, a contract to purchase a commodity at a fixed price for delivery at a future date has embedded in it a derivative that is indexed to the price of the commodity.

Embedded Derivatives

An embedded derivative is a feature within a contract, such that the cash flows associated with that feature behave in a similar fashion to a stand-alone derivative.

Embedded Derivatives

In the same way that derivatives must be accounted for at fair value on the balance sheet with changes recognized in the income statement, so must some embedded derivatives

Embedded Derivatives

PAS 39 requires that an embedded derivative be separated from its host contract and accounted for as a derivative when: [PAS 39.11]

Embedded Derivatives

If an embedded derivative is separated, the host contract is accounted for under the appropriate standard (for instance, under PAS 39 if the host is a financial instrument)

Embedded Derivatives

Example of embedded derivatives that are not closely related to their hosts (and therefore must be separately accounted for) include:

- the equity conversion option in debt convertible to ordinary shares (from the perspective of the holder only);

Embedded Derivatives

Example of embedded derivatives that are not closely related to their hosts (and therefore must be separately accounted for) include:

- commodity indexed interest or principal payments in host debt contracts;

Embedded Derivatives

Example of embedded derivatives that are not closely related to their hosts (and therefore must be separately accounted for) include:

- cap and floor options in host debt contracts that are in-the-money when the instrument was issued;

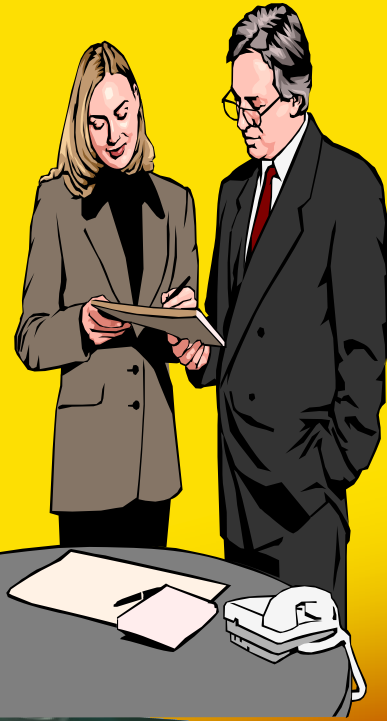
Embedded Derivatives

Example of embedded derivatives that are not closely related to their hosts (and therefore must be separately accounted for) include:

- leveraged inflation adjustments to lease payments;

Embedded Derivatives can't be separated from host contract

- the entire combined contract must be treated as a financial asset or financial liability that is held for trading
- Re-measured to fair value at each reporting date,
- with value changes in profit or loss). [PAS 39.12]



Classification
PAS 39.45

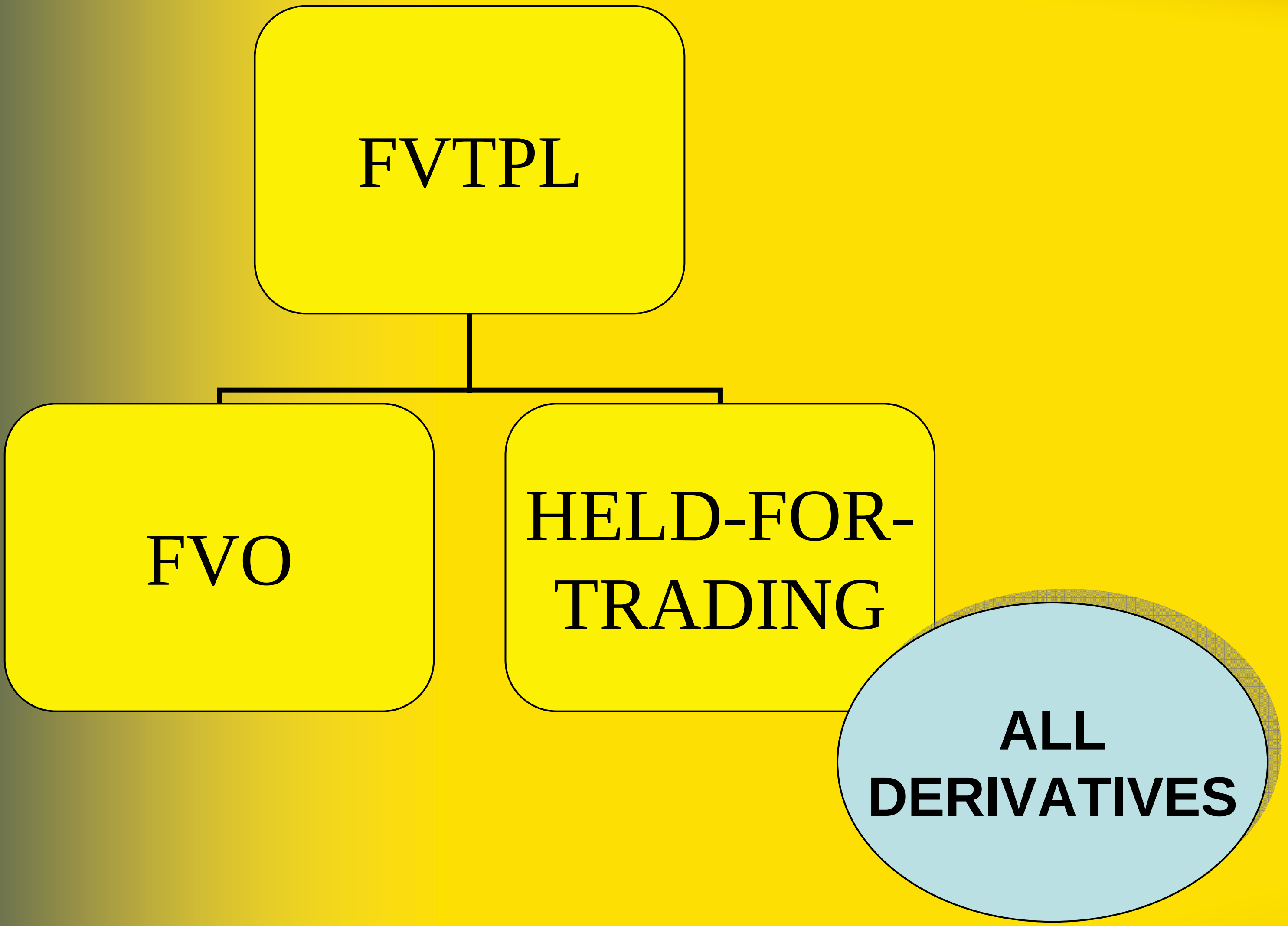
Financial Assets

- FVTPL
- Available for Sale
- Loans & Receivables
- Held to Maturity Investments

used to determine how a particular financial asset is recognized and measured in the financial statements.

FVTPL

- FVO
- HELD-FOR-TRADING


FVTPL
FVO
HELD-FOR-TRADING
ALL DERIVATIVES

Designated FVTPL	Held for trading
RDE1 includes any financial asset that is designated on initial recognition as one to be measured at fair value with fair value changes in profit or loss.	includes financial assets that are held for trading. All derivatives (except those designated hedging instruments) and financial assets acquired or held for the purpose of selling in the short term or for which there is a recent pattern of short-term profit taking.

Slide 35

RDE1 RDE, 3/18/2005

PAS 39

Fair Value thru Profit & Loss

When designated as FVTPL

on initial recognition

Measurement

Fair value

FV changes

recognized in profit or loss.

PAS 39
Available for Sale
(non-derivative)

When designated as AFS	on initial recognition
Measurement	Fair value
FV changes	recognized directly in equity

PAS 39
Available for Sale

Interest on AFS

Recognition in Income (Effective Interest Method)

Impairment Losses

Recognition in Income

FOREX gain & losses

Recognition in Income

cumulative gain or loss that was recognized in equity is recognized in profit or loss when an available-for-sale financial asset is derecognized.

PAS 39
Loans & Receivables
(non-derivative)

When designated as L&R — on initial recognition

↓

Measurement — Amortized Cost

↓

Gains & Losses — recognized in P & L

PAS 39
Loans & Receivables

characteristic — with fixed or determinable payments

↓

classification — Originated or Acquired

↓

Market — not quoted in an active market

PAS 39
Loans & Receivables

- Loans and receivables for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, should be classified as **available-for-sale**

Held to Maturity

- If an entity sells a held-to-maturity investment
  - other than in insignificant amounts or
  - as a consequence of a non-recurring, isolated event beyond its control that could not be reasonably anticipated,
- all of its other held-to-maturity investments must be reclassified as **available-for-sale** for the current and next two financial reporting years. [IAS 39.46(b)]

PAS 39
Held-to-Maturity

characteristic	**non-derivative financial assets with fixed or determinable payments**
Intention	**to hold to maturity and that do not meet the definition of loans and receivables**
Measurement	At amortized cost

Classification
PAS 39.47

Financial Liabilities

FVTPL

At Amortized Cost
(Effective Interest Method)

DESIGNATED

Designated as FVTPL at initial recognition

HELD-FOR-TRADING

Obligation for securities borrowed in a short sale

- ***Classification of Financial Liabilities***
- IAS 39 recognises two classes of financial liabilities: [IAS 39.47]
- Financial liabilities at fair value through profit or loss.
- Other financial liabilities measured at amortised cost using the effective interest method.
- The category of financial liability at fair value through profit or loss has two subcategories:
- **Designated.** A financial liability that is designated by the entity as a liability at fair value through profit or loss upon initial recognition.
- **Held for trading.** A financial liability classified as held for trading, such as an obligation for securities borrowed in a short sale, which have to be returned in the future.

Initial Recognition

- of a financial asset or a financial liability
- when, and only when, the entity becomes a party to the contractual provisions of the instrument,
- subject to the provisions in respect of regular way purchases.
- [PAS 39.14]

Regular Way

- **purchases or sales of a financial asset**
- recognized and derecognized using either
  - trade date or
  - settlement date accounting.

Choice of Method

- Is an accounting policy [PAS 39.38]

RECOGNITION

Classification	FINANCIAL ASSETS	FINANCIAL LIABILITIES	DERIVATIVES
Recognition	On the Balance Sheet	On the Balance Sheet	On the Balance Sheet
Measurement	at fair value	At fair value	At fair value

including transaction costs, for assets and liabilities not measured at fair value through profit or loss

DERIVATIVES

- Historically, in many parts of the world, derivatives have not been recognized on company balance sheets.
- at the time the derivative contract was entered into, there was no amount of cash or other assets paid.
- Zero cost justified non-recognition, notwithstanding that as time passes and the value of the underlying variable (rate, price, or index) changes, the derivative has a positive (asset) or negative (liability) value.

SUBSEQUENT TO INITIAL RECOGNITION

Classification	FINANCIAL ASSETS	FINANCIAL LIABILITIES	DERIVATIVES
Recognition	On the Balance Sheet	On the Balance Sheet	On the Balance Sheet
Subsequent Measurement	at fair value	At fair value	At fair value

Exceptions follow in next slide

SUBSEQUENT TO INITIAL RECOGNITION

Classification	LOANS & RECEIVABLES	HELD TO MATURITY	NON-DERIVATIVE FINANCIAL LIABILITY	INVESTMENTS IN EQUITY INSTRUMENTS with no reliable value
Recognition	On the Balance Sheet	On the Balance Sheet	On the Balance Sheet	On the Balance Sheet
Subsequent Measurement	AMORTIZED COST	AMORTIZED COST	AMORTIZED COST	at COST

USE EFFECTIVE INTEREST METHOD

FAIR VALUE

General Definition

amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction

Active Market

Quoted market prices are the best evidence of fair value and should be used, where they exist, to measure the financial instrument.

No Active Market

If a market for a financial instrument is not active, an entity establishes fair value by using a valuation technique

No Active Market, estimates can’t be made

an entity must measure the equity instrument at cost less impairment.

VALUATION TECHNIQUE

General Definition

makes maximum use of market inputs and includes recent arm's length market transactions, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models

Acceptable Valuation Technique

An acceptable valuation technique incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments.

EFFECTIVE INTEREST RATE METHOD

- Amortized cost is calculated using the effective interest method
- the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability.

Financial assets

- not carried at fair value though profit and loss
- subject to an impairment test
- If expected life cannot be determined reliably, then the contractual life is used.

PAS 39 Fair Value Option

- PAS 39 permits entities to designate, at the time of acquisition or issuance
- any financial asset or financial liability is measured at fair value, with value changes recognized in profit or loss.
- Once an instrument is put in the fair-value-through-profit-and-loss category, it cannot be reclassified out.

IAS 39 Available for Sale Option for Loans & Receivables

- permits entities to designate, at the time of acquisition, any loan or receivable as available for sale, in which case it is measured at fair value with changes in fair value recognized in equity.

Impairment

- A financial asset or group of assets is impaired
  - impairment losses are incurred only if there is objective evidence as a result of one or more events that occurred after the initial recognition of the asset.
- An entity is required to assess at each balance sheet date whether there is any objective evidence of impairment.
- If any such evidence exists, the entity is required to do a detailed impairment calculation to determine whether an impairment loss should be recognized.
- [PAS 39.58]

Collective Impairment

- Individual assets that are individually assessed and for which no impairment exists are grouped with financial assets with similar credit risk statistics and collectively assessed for impairment. [PAS 39.64]

- If, in a subsequent period, the amount of the impairment loss relating to a financial asset carried at amortised cost or a debt instrument carried as available-for-sale decreases due to an event occurring after the impairment was originally recognised, the previously recognised impairment loss is reversed through profit and loss. Impairments relating to investments in available-for-sale equity instruments are not reversed. [IAS 39.65]

IMPAIRMENT LOSS

Classification	**FINANCIAL ASSETS carried at Amortized Cost**	**AFS DEBT INSTRUMENT**
Reversal of Impairment	**Thru PROFIT & LOSS**	**NOT ALLOWED PAS 39.65**