

# **Deliberation on IFRS**

**by**

**CA. D.S. Rawat**

**Partner, Bansal & Co.**



**International  
Accounting Standards  
Board®**

# FINANCIAL INSTRUMENTS

## IAS-32, IAS-39 & IFRS-7

D.S. RAWAT

FCA

Partner, Bansal & Co.

# **ACCOUNTING FOR FINANCIAL INSTRUMENTS**

- IAS-39 Recognition and Measurement
- IAS-32 Presentation
- IFRS -7 Disclosure

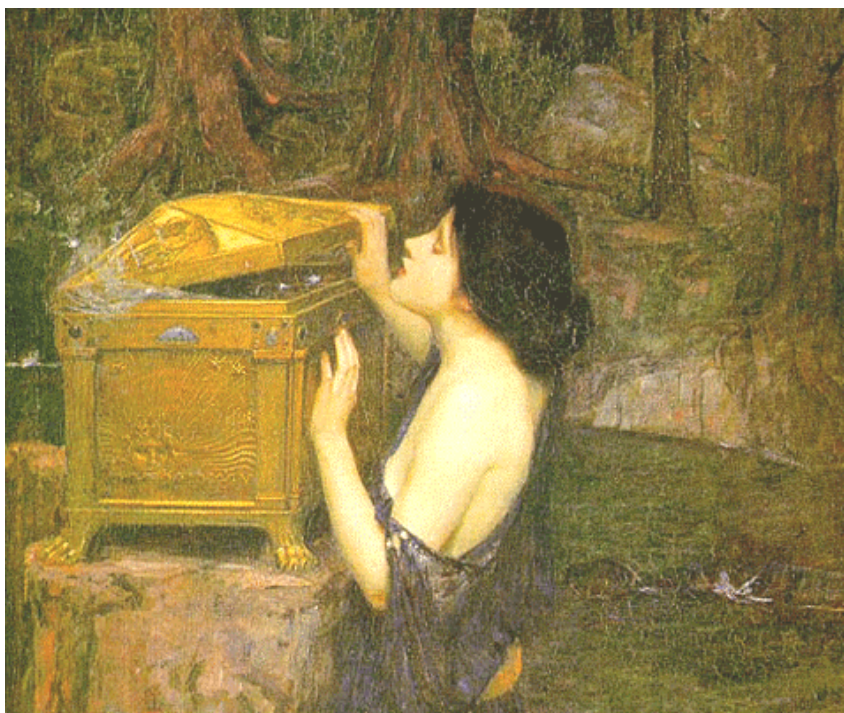
# What is Financial Instruments?

Not limited to

- Investment
- Capital market instruments

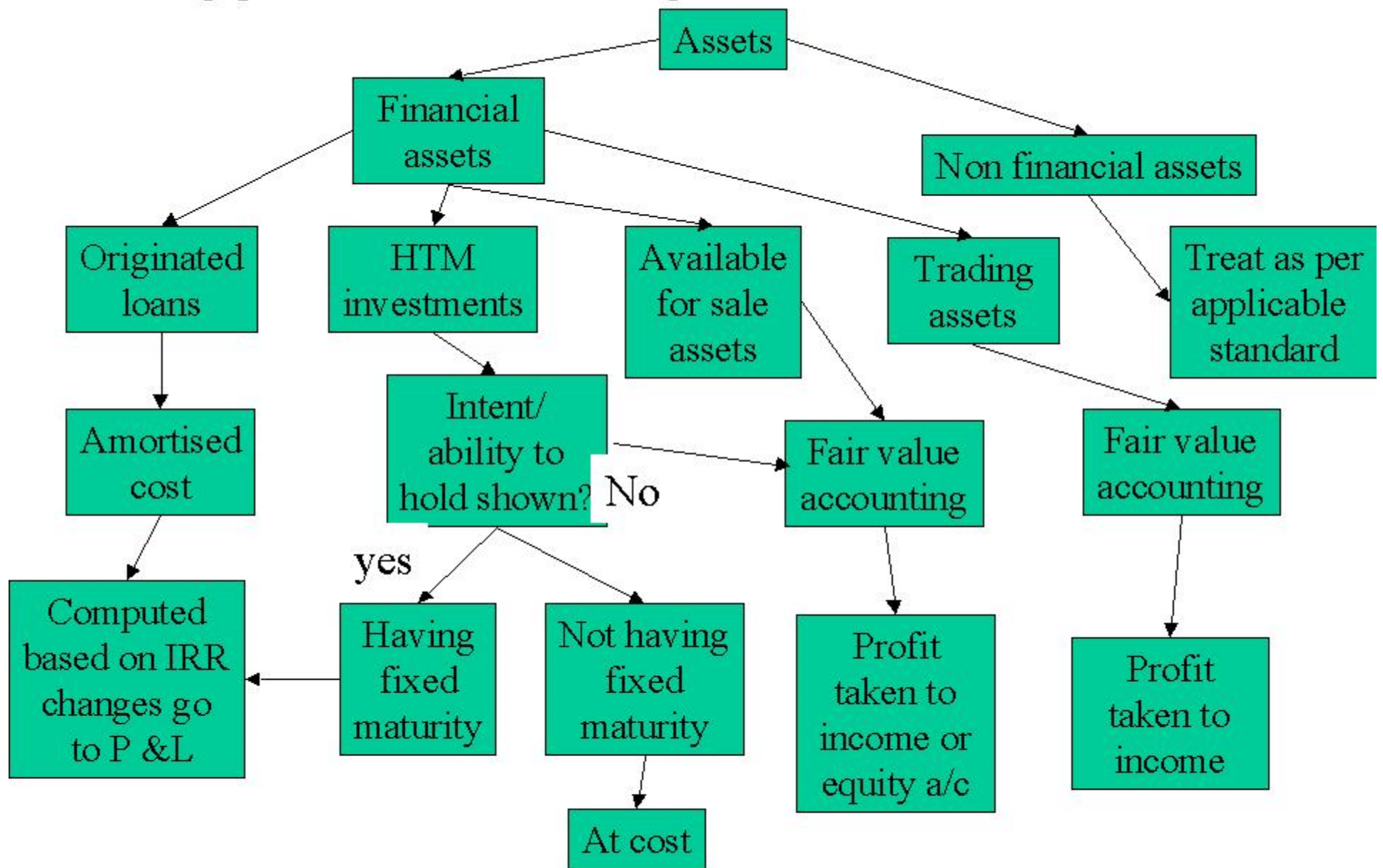
Includes

- Financial Asset
- Financial Liability



IAS 32,39, IFRS -7,  
the Pandora box

# The big picture of accounting for financial assets



# Financial Instruments is

Any Contract that gives rise to –

- A financial asset of one entity
- A financial liability or equity of another

# Financial Asset

- Cash
- Equity of another entity
- Contractual right to receive –
  - cash
  - another financial asset
- Forward Contract to receive financial asset



# Examples of Financial Asset

- Cash
- Investment
- Loans
- Receivables (Debtors)

# Examples of Non-Financial Asset

- Inventories
- Prepaid expenses
- Refund of taxes
- Fixed Assets

# Financial Liability

Obligation to deliver -

- Cash
- Another financial asset

Forward Contract to be settled in own equity instrument

# Examples of Financial Liability

- Debentures
- Creditors
- Forward Contracts
- Redeemable Preference Shares

# Examples of Non-Financial Liability

- Own Equity
- Commodity Exchange Contracts
- Taxes Payable
- Warranty Obligation
- Insurance Contracts

# Example

Abhishek deposited Rs. 500,000 in State Bank of India.

A deposit of cash is financial asset for Abhishek as it represents contractual right of Abhishek to obtain cash or draw cheque from the bank equally it is financial liability for the State Bank of India, as bank has to pay the money back to Abhishek whenever he want.

# Example

L Ltd. sold goods to M Ltd. for Rs. 10 lakhs on credit. The payment will fall due on December 31, 2008. As per the purchase agreement, M Ltd. will issue an adequate number of its own equity shares to settle the obligation. The number will be determined by dividing the amount due (Rs. 10 lakh) by market price of M Ltd's shares on December 31, 2008.

M Ltd should recognize the payment due to L Ltd as a liability, although the obligation will be settled by issue of equity shares. On issue of equity shares, the liability will get extinguished and equity in the books of M Ltd will increase by the corresponding amount.

# Example

SAIL advanced house building loan of Rs. 10 lakh at concessional rate of 4% p.a.

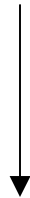
Is it a financial asset for SAIL?



# Debt Equity Classification

Factor in distinguishing a financial liability  
and an equity is -

The existence of a contractual obligation



for the issuer

# What is Equity?

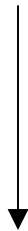
It represents a residual interest in the net assets of the issuer

- Shares, options, warrants

# Debt Equity

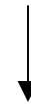
Does the issuer potentially have an obligation to settle gross in cash or in a variable number of own shares

No



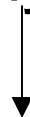
Liability

Yes



Will settlement only be the exchange of a fixed number of shares for a fixed amount (no alternative of cash settlement in any circumstances)

No



Derivative

Equity

Yes



# Preference Shares

Is it liability or equity

Component – Principal, Dividend

# Compound Financial instrument

- Convertible Debenture
- Convertible Preference shares

# Example

Induga Ltd has issued 5000 convertible debentures with a face value of Rs. 100 per debentures. The interest rate on the debentures is 5%. The debenture holders have the option of converting these debentures into ordinary shares at the end of four years. The prevailing market rate for a similar debt which does not have a conversion right is 7%

Present Value (PV) of principal : Rs. 5,00,000  
at end of 4 years discounted to PV

(5,00,000 x 0.763)

Rs. 3,81,500.00

PV of interest Rs. 25,000 annually in arrears  
for 4 years (25,000 x 3.387)

84,675.00

**Liability Portion**

**4,66,175.00**

**Equity portion**

**33,825.00**

# Derivatives

- Underlying items
- No/small initial investment
- Settled - future date

Forwards

Swaps

Futures

Options

# Example

B Co. enters into a contract. Under this contract, B Co. will pay Rs. 5,000 if ABC's share price increases by Rs. 10 or more during a eight-month period; it will receive Rs. 5000 if the share price decreases by Rs. 10 or more during the same eight-month period; and no payment will be made if the price swing is less than Rs. 10 up or down

In this case, the settlement amount changes with ABC's share price. Although there is no notional amount to determine the settlement amount, there is a payment provision that is based on changes. All the other characteristics of a derivative mentioned above (the value of an instrument changes, no initial investment is needed and it can be settled at a future date) are also present.

Hence, the contract entered into by B Co. is a derivative



# Embedded Derivatives

An embedded derivative is a financial instrument (Derivative instruments) which is combined with a non-derivative host contract.

**Example:** X Co. holds convertible debenture of Y Co. which are convertible in equity shares.

Host Contract – debenture. Embedded derivative – conversion option.

# **Embedded Derivatives - Example**

**X Co. sells furniture to Y Co. in US\$ both companies are in India and make purchase and sales of furniture in rupees. The entire sale contract which will be settled in US\$ is hybrid contract in which is included the embedded derivative of foreign exchange Rupees/US\$ forward as the cash flow will also be dependent not only on the price of the furniture but Rupees/US\$ exchange rate.**

# Scope

Does not cover –

- Obligation arising under insurance contracts
- Interests in subsidiaries
- Interests in associates
- Interests in joint ventures
- Employee benefit plans
- Right and obligation under lease to which AS-19, “Leases” applies subject to certain exceptions.

# Classification of Financial Asset

- Financial assets at fair value through profit or loss
- Held to maturity investments
- Loans and receivables
- Available for sale

# Classification of Financial Liability

- Financial liabilities at fair value through profit and loss
- Other financial liabilities

# Fair Value

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.

- Active Market- Quoted price
- No Active Market – Valuation techniques – DCF, Option pricing model
- No Active Market – Equity investments less impairment loss

# Effective Interest method

Under IAS39, amortised cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the net carrying amount at initial recognition.

# Accounting & Measurement

## Financial Asset

### Fair Value through Profit and loss (FVTPL)

#### Initial -

Measured at fair value on the date of acquisition which is the acquisition price.

#### Subsequent -

At fair value



# Accounting & Measurement

## Financial Asset

### Available for sale

#### Initial -

Measured at fair value on the date of acquisition which is the acquisition price plus transaction costs that are directly attributable to the acquisition or issue of the financial assets.

#### Subsequent -

At fair value

Change in fair value between two reporting dates is charged/credited to a separate component of equity, say, Investment Valuation Reserve.

# Accounting & Measurement

## Financial Asset

### Held to maturity

#### Initial -

Measured at fair value on the date of acquisition which is the acquisition price plus transaction costs that are directly attributable to the acquisition or issue of the financial assets.

#### Subsequent -

At amortized cost applying effective interest rate.

# Accounting & Measurement

## Financial Asset

### Loans and receivables

#### Initial -

Short-term receivable with no stated interest rate should be measured at original invoice amount if the effect of discounting is immaterial. Other items are measured at fair value on the date of acquisition which is the acquisition price plus transaction costs that are directly attributable to the acquisition or issue of the financial asset

#### Subsequent -

At amortized cost applying effective interest rate.

# **Accounting & Measurement**

## **Financial Asset**

**Financial assets, fair value of which  
cannot be reliably measured**

**Initial -**

At cost

**Subsequent -**

at cost.

# Accounting & Measurement

## Financial Liability

### Financial liabilities at fair value through profit and loss

**Initial -**

At fair value

**Subsequent -**

At fair value

# **Accounting & Measurement**

## **Financial Liability**

**Financial liability arising out of continuing involvement of transferred asset and does not qualify for de-recognition.**

### **Initial -**

Measured at amortised cost or fair value.

### **Subsequent -**

Measured at amortised cost or fair value

# Accounting & Measurement

## Financial Liability

### Financial guarantee

#### Initial -

As per IAS-37

#### Subsequent -

Higher of the –

- Amount initially recognized less cumulative amortization recognized.
- Valuation as per IAS-37

# Accounting & Measurement

## Financial Liability

Other financial liabilities including debentures, bonds, preference shares classified as financial liabilities, loans, advances, payables.

### **Initial -**

At fair value

### **Subsequent -**

At amortised cost.



# Accounting for Embedded Derivative

When the embedded derivative is separated, the host contract is classified as financial instrument analyzing its independent features. The embedded derivative is classified as FVTPL .

# Impairment of financial assets

## Impairment Triggers –

- Significant financial difficulty of the issuer
- Default/Delinquency in interest/principal payment
- Collection pattern indicating that the entire face value of portfolio of financial asset will not be collectable
- Granting of concession to borrower which would otherwise not be offered in normal business
- Disappearance of an active market
- High probability of issuer's bankruptcy

# Assessment of Impairment

*Financial assets carried at amortised cost –*  
Impairment loss

= Carrying amount i.e., amortised cost less PV of estimated future cash flow discounted at original effective interest rate.

Impairment loss is charged to profit and loss account

# Assessment of Impairment

*Short-term receivable with no stated interest rate carried at original invoice amount –*

Only difference is that impairment loss measured using undiscounted estimated future cash flows.

Impairment loss

= Carrying amount i.e., amortised cost Less  
Undiscounted estimated future cash flows.

# Assessment of Impairment

*Financial assets carried cost –*

Impairment loss = Carrying amount i.e., cost Less  
Present value of estimated future cash flow  
discounted at current market rate of return for  
similar financial asset.

It is charged to profit and loss account

# Assessment of Impairment

## ***Available for sale financial assets-***

- I. Find out difference between the current fair value of the financial asset and its acquisition cost; this is impaired loss.*
- II. Check if any impairment loss is already charged to profit and loss account*
- III. Find out cumulative loss recognized in the equity.*
- IV. Charges –  
Cumulative loss recognized in equity in step (iii) less impairment loss already charged to profit and loss account as per step (ii)  
Impairment loss of an available for sale financial asset (other than a debt instrument) is not reversed through profit and loss account. However, for a debt instrument the reversal is carried through profit and loss account.*

# Assessment of Impairment

## Example

X Ltd. purchased equity shares of Y Ltd. and classified them as available for sale financial asset. On initial recognition, the fair value of the financial asset, i.e., its acquisition cost plus transaction cost was Rs. 10 lakhs. At the end of Year 1 fair market value of such shares was Rs. 9.50 lakhs. At the end of Year 2 the fair market value was just Rs. 7 lakhs – the entity found objective evidence of deterioration of business condition of Y Ltd. causing impairment. However, applying cash flows and other valuation model it assesses that fair value of the shares should be Rs. 7.90 lakhs. The market has over-reacted to the bad news; and current market price reflects distress selling price. As per the market report, Y Ltd share may recover from there as well. Accordingly, it has decided to charges Rs. 1.60 lakhs as impairment loss. In Year 3, the fair market value of this asset was Rs. 4.50 lakhs because of reported heavy loss incurred by Y Ltd. and management fraud. It is highly likely that Y Ltd. will go for bankruptcy and equity shareholders will get only residual value. X Ltd. has estimated that based on residual value the financial asset should be valued at Rs. 5 lakhs .

# Assessment of Impairment

<u>On acquisition</u>		(Rs. in lakh)
Available for Sale Financial Assets	Dr.	10.00
To Cash		10.00
<u>Year End 1</u>		
Fair Value Reserve	Dr.	0.50
To Available for Sale Financial Assets		0.50
<u>Year End 2</u>		
Impairment Charges	Dr.	1.60
To Available for Sale Financial Assets		1.60
P&L A/c	Dr.	1.60
To Impairment Charges		1.60
P&L A/c	Dr.	0.50
To Fair Value Reserve		0.50
<u>Year End 3</u>		
Impairment Charge	Dr.	2.90
To Available for Sale Financial Assets		2.90
P&L A/c	Dr.	2.90
To Impairment Charges		2.90



# **De-recognition of financial asset**

- **The contractual rights to the cash flows from the financial asset expires**
- **It transfers the financial asset and the transfer qualifies for de-recognition**

# **De-recognition of financial asset**

- **Completes de-recognition of financial asset**
- **Partial de-recognition**
- **De-recognition combined with recognition of new liability**

# **Completes de-recognition**

A transferor may sell financial assets receiving in exchange, cash or other assets with no continuing involvement with the assets sold

# Completes de-recognition

Hill-Top Ltd. sells a portfolio of receivables with a carrying amount of Rs.1,00,000 to Garhwal Ltd. for a fixed amount of Rs. 90,000 with no recourse to Hill-Top Ltd in the case of bad debts. Garhwal Ltd. assumes the full risk of collection, which is reflected in the price paid. Debtors are notified of the transfer and directed to send payments to Garhwal Ltd. Hill-Top Ltd. has lost control of the asset and Garhwal Ltd. has assumed full risk without recourse to Hill-Top Ltd. if any of the debtor's defaults. The transaction is treated as an outright sale and asset is de-recognized.

# **No de-recognition of an asset**

At the other extreme is a transaction where the buyer has an unconditional option to return the assets at the original price, usually with interest. It might choose to do so, for example, if a receivable become doubtful. Again, the accounting is straightforward.

The transaction is treated as financing, with both asset and liability on balance sheet, because control of the assets is not transferred.

# No de-recognition of an asset

S Ltd. sells certain receivable, due in 6 months with a carrying amount of Rs. 1,00,000 to P Ltd. for a cash payment of Rs. 95,000 with full right of recourse. Under the terms of the recourse provision, the transferor is obliged to re-acquire certain receivables at the original price plus interest, if P Ltd. chooses to return them. P Ltd. has an unconditional put option on the assets transferred. The seller is obliged to re-purchase the receivables transferred on terms that effectively provide the buyer with a lender's return. Consequently, the seller has not lost control of the receivables and is still exposed to the risk of default. The receivables are not removed from S Ltd's balance sheet and the transaction should be treated as a collateralized borrowing.

In S Ltd's books, the Rs. 95,000 received is recognized as a liability. It is measured at amortised cost, with interest expense of Rs. 5,000 being recognized over its six-month maturity. The receivables continue to be recognized at the lower of cost and net realizable value in the usual way. Cash received (either by the buyer or the seller, depending on the agreement) reduces the receivables balance and is used to repay the liability. If receivables are 'returned' to the seller, the cash paid is also a partial repayment of the liability. The carrying amount of the receivable returned may be impaired.

# Partial de-recognition

For example, a transferor may pledge financial assets as collateral or may retain servicing rights, or retain some or all of the credit risk in the assets transferred. In recent years such transfers have grown in volume, variety and complexity, frequently raising the issues of whether the assets should be considered to have been sold or as collateral for borrowings and whether or not transfer should be recognized.

# De-recognition of financial liability

A financial liability (or a part of financial liability) is de-recognized only when the liability is extinguished. That is obligation under the contract is discharged or cancelled or expired.

The obligation is discharged by paying the creditor in cash, other financial assets or goods or services, or obligation is legally released.



# Hedge Accounting

Entities use a risk management technique called hedging, whereby the entity tries to reduce the impact of future potential costs or losses.

Hedging is shelter one's self from danger, risk, duty, responsibility etc.,

# Hedge Accounting

Hedge accounting (HA) is technique

*That*

Changes the normal basis for recognizing gains & losses

*On*

Associated hedging instruments and hedged items

*So That*

Both are recognized in profit and loss account in the same  
accounting period

# Qualifying for Hedge Accounting

There are four aspects related to hedge accounting:

- There has to be a hedged item specifically designated
- There has to be a hedging instrument
- There has to be a relationship between the hedged item and the hedging instrument with formal documentation.
- The relationship should be effective so as to offset the effects on profit or loss of changes in the fair value of the hedging instrument and the hedged item.

# Classification of Hedge Accounting

- A fair value hedge, which hedges the exposure to changes in the fair value of an item or transaction
- A cash flow hedge, which hedges the exposure to changes in the expected cash flows
- Hedges of a net investment in an overseas operation, which reduce the exposure of an entity to foreign operations.

# Classification of Hedge Accounting

Example :

A Tea house fixed the value of its tea inventory by entering into a future contract.

Here the entity is hedging the risk of changes in the tea inventory's overall fair value. This is an example of **a fair value** hedge that often occurs in practice.

# Classification of Hedge Accounting

Example :

Entity X, which has a highly **probable** sale of a commodity in the future at the then prevailing market price, 'fixes' the selling price of the goods by entering into a future contract.

By doing this, the entity is hedging the risk of variability in the cash flows to be received on the sale due to changes in the good's market price. This is an example of **a cash flow hedge**.

# Classification of Hedge Accounting

## Example :

Induga Ltd, an Indian company, has an equity method investee in a foreign country. The functional currency of the investee is the Mauritian Rupee (MR). On 01.10.2008, Induga Ltd's investment in the investee is 10,000 MR. On 01.10.2008, Induga Ltd also enters into 5-month forward contract to sell 10,000 MR. on 01.03.2009 at the forward rate on 01.10.2008 of INR 1.51. Induga Ltd enters into the forward contract to hedge its foreign currency risk exposures associated with its investment in its equity method investee. Each period the investee pays a dividend equal to its net income for the period. The exchange rates are as follows:

Date	Spot Rate	Forward Rate for 01.03.2009
01.10.2008	1MR=INR 1.5	5-month forward rate : 1MR=INR1.5
31.12.2008	1MR=INR1.58	2-month forward rate:1MR=INR1.60
01.03.2009	1MR=INR1.56	

Interest Rate 6%

# Presentation

- Debt equity classification
- Compound financial instruments
- Treasury shares
- Interest, Dividend, losses and gains
- Offsetting of a financial asset and a financial liability



# Treasury Shares

- No gain or loss should be recognized in statement of profit and loss on the purchase, sale, issue or cancellation of an entity's own equity instruments.
- Consideration paid or received should be recognized directly in equity.
- Treasury shares are not recognized as financial assets,
- If an entity holds its own equity on behalf of other, for example, a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's balance sheet.
- Disclosures- The amount of treasury shares held is disclosed separately either on the face of the balance sheet or in the notes.

# Interest, Dividends, Losses & Gains

- Interest, dividends, losses and gains related to a financial instrument that is a financial liability are recognized as an expense in the profit or loss
- Preference shares as a financial liability must recognize the dividend payments on the shares as interest expense).
- Transaction costs relating to an equity transaction shall be accounted for as a deduction from equity, net of any related income tax benefit

# ***Offsetting a financial asset and a financial liability***

- Has a current legally enforceable right to set off the recognized amounts, and
- Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously

# ***Disclosure*** [IFRS-7]

Disclosures requirements for –

- Different categories of financial assets
- Different categories of financial liabilities
- Re-classifications of financial assets
- De-recognition of financial assets and financial liabilities
- Financial assets pledged or held as collateral
- Allowances for credit losses

# ***Disclosure*** [IFRS-7]

Disclosures requirements for –

- Compound financial instruments with multiple embedded derivatives
- Defaults and breaches for loan payable
- Income, expense, gains or losses recognized in profit and loss account
- Accounting policies followed
- Hedge accounting
- Fair value determination for financial assets and financial liabilities
- Risk disclosures

# Risk Disclosures

- Credit risk
- Liquidity risk
- Market risk

# Credit Risk

## ***Qualitative Risk Disclosure -***

- The exposure to the risk and how they arise
- The entity's objective, policies and processes for managing the risk and the methods used to measure the risk
- Any changes to these disclosures from the previous reporting period

# Credit Risk

## ***Quantitative Risk Disclosure –***

- The maximum credit exposure net of any impairment losses,
- Description of collateral and other credit enhancement available.
- Information relating to the credit quality
- Carrying amount of impaired or past due financial assets whose terms have been renegotiated
- Age analysis of financial assets that are past due at the reporting date but not impaired
- An analysis of individually impaired financial assets as at reporting date including the factors considered by the entity in determining impairment, plus a description of the collateral or other credit enhancements and its estimated fair value held by the entity's security



# Liquidity Risk

- Financial liabilities must be disclosed by contractual maturity based on undiscounted cash flows.
- This will be different from the balance sheet amount as the balance sheet amount is based on discounted cash flows.
- The application guidance of IFRS-7 suggests the time bands that may be used in preparing the contractual maturity analysis for liabilities.
- It also expands the disclosure of liquidity risk to include a description of how liquidity risks are managed.

# Market Risk

- Foreign Currency Risk
- Interest Rate Risk
- Price Risk

# Impact of IAS-39

On Balance Sheet –

- Debt Equity Ratio
- Off Balance Sheet item
- Presentation of asset/liability
- Fair value presentation

# Impact of IAS-39

On Profit and loss account –

- Net profit
- Interest and dividend
- Un-realized profit or loss
- Fair value impact

# Impact on financial asset and liability

- Re-classification
- Fair value presentation
- Off balance sheet financial asset/liability
- De-recognitions

# Case Study- Austrian Airlines

## Risk management system

Because it is in the international aviation sector, the Austrian Airlines Group operates in a complex economic environment in which conditions are constantly changing and experiences a range of types of risk as a result. To ensure that it continues to enjoy long-term success under such conditions, the company has put in place a system of targeted management of risks and opportunities.

The strategy of the Austrian Airlines Group is based on the basic principles of value-oriented corporate management. This means that the Group is ready to accept commercial risk as long as the business activities undertaken and resultant additional income opportunities can reasonably be expected to produce an increase in the value of the company.

The Austrian Airlines Group uses a system of risk management organised according to a decentralized concept, featuring a single risk manager and eight decentralized risk coordinators to cover all divisions of the Board of Management. The central risk management office is responsible for the (ongoing) conceptual development, implementation and maintenance of the Group-wide risk management system of the Austrian Airlines Group. A specialist department in its own right, the risk management office supports divisions and subsidiaries in tackling risk management issues. Essentially this support includes helping those divisions and subsidiaries to prepare and draw up risk definitions and analyses; deriving and subsequently coordinating risk improvement measures; and providing feedback on the data used. The risk management office is also responsible for writing risk management reports for the Board of Management.

# Case Study- Austrian Airlines

## Risk management system

Every division of the Board of Management and subsidiary has a risk committee whose responsibility it is to discuss the key risks in the respective field, check the plausibility of data collection and evaluation, and to examine the appropriateness of the measures taken to manage the risk. These risk committees consist of members of the Group Board of Management, executive management in the case of subsidiaries, the respective executives and risk coordinator in question.

The risk management of the Austrian Airlines Group is based on a systematic process of risk identification, evaluation and management covering the entire Group. This process, which takes place twice a year, guarantees that the relevant risks in the Group are acknowledged and that the measures necessary to overcome them are scrutinised thoroughly. The risk inventory of the Austrian Airlines Group generated as a result of this approach puts the Board of Management in a position to recognise difficult developments at an early stage, before the Group is compromised in any way, and to implement countermeasures if necessary.

# Foreign Currency Risk

Foreign currency risks are valued from both the 'cash flow at risk' and 'value at risk' perspectives, and are hedged and controlled with the objective of planning security and result optimisation. From a cash flow perspective, the USD position is relatively neutral when holdings of dollar-dependent currencies in the Group are taken into account, while in JPY surpluses exist from ticket sales in the Japanese market. On the assets side, the aircraft fleet represents a book value of around EUR 2.1 billion denominated in US dollars. According to IFRS, however, aircraft are not subject to 'mark to market' valuation and therefore cannot be used to offset liabilities in dollars. Due to the positive exchange rate trend for Austrian Airlines, liabilities held in Japanese yen were partly reduced. Financing surpluses exist in CHF, with the aim of using the favourable Swiss interest rate. A call option was sold on a short-term loan, with the premium received having been collected upon maturity of the option in September 2006. Where necessary, derivative instruments will continue to be used with first-class partners for the settlement of balances or the closing of open positions. As at 31.12.2006, hedging transactions existed using financial derivatives for the coverage of exchange rate and interest rate fluctuations. The market values of financial derivatives as reported in the following tables correspond to the particular price at which an independent third party would assume the rights and/or obligations from this financial instrument from the Austrian Airlines Group. The market values were determined on the basis of the market information available on the balance sheet date. Negative signs mean a possible obligation in a sale or a realisation of the item at the financial year-end. The following currency hedging, reported according to business types, exists in relation to banks and other financial institutions..



# Interest Rate Risk

The programme to reduce interest rate risks was rigorously continued in 2006. At the end of 2006, the proportion of financing covered by fixed interest rates was around 61.4% (53.0% last year). As a result, the risks to the Group from fluctuations in interest rates have been suitably reduced.

New financing is principally concluded in EUR at fixed rates of interest; at the same time, hedging transactions amounting to approximately EUR 177.6m are in place that are counted as a EUR liability with fixed interest for the Group. Similarly, subsequent financing is converted into EUR with fixed interest rates, where the market allows. See Note 32 for details of the maturities of fixed-interest and variably interest-bearing liabilities .

# Price Risk

The price risks associated with the fuel price trend – fuel expenditure represents around 19.3% (17.5% the preceding year) of operating expenses – were partially hedged in 2004 by means of fixed price transactions ('swaps') on the basis of the crude oil price and fixed price transactions with a limited payout ('capped swaps'). This approach increases planning security and, although it cannot provide protection against persistent, long-term price increases, helped to absorb the impact of the sharp increase in oil prices in 2004. In such cases, there remains no alternative to coverage other than the appropriate increases in flight revenues and the temporary introduction of fuel surcharges. In the past, sharp increases in the price of oil were normally triggered by brief crises and tended to be relatively short-term in nature. The increase in the cost of kerosene in the report period once again deviated from the expectations of forecasters, once again rising significantly above the figure for the preceding year. The average jet fuel price, which stood at USD 562 per ton in 2005, rose to an average of USD 645 per ton in 2006, also exceeding the internal planning assumptions of the Austrian Airlines Group of USD 615 per ton. The trend was irregular over the year as a whole: while the kerosene price rose continually in the first half-year of 2006, reaching a new record level of more than USD 750 per ton at the beginning of the third quarter, September saw the price fall back to its level at the beginning of the year. Towards the end of the year, the kerosene price eventually stood at around USD 600 per ton.

The fuel hedging policy of the Austrian Airlines Group is based on a comprehensive assessment of all risks involved. The Group pursues a strategy of risk minimization. In the past, the challenging financial situation of the company has left no room for manoeuvre in which to react to short-term price spikes. Following the recent successful capital increase, however, the Group is now considering taking measures to protect against the risk of price change within a defined hedging framework. ■

# Risk of Non Payment

In the majority of cases, the sale of passage and freight documents is handled via agencies within the sphere of influence of IATA. These agencies are overwhelmingly connected with country-specific clearing systems for the settlement of passage or freight sales. Individual agents are checked by the particular clearing houses. The credit risk from sales agents is relatively low due to their dispersion worldwide. Unless the agreements upon which a payment is based explicitly state otherwise, claims and liabilities arising between the airlines are usually settled on a bilateral basis or via a clearing house of the International Air Transport Association (IATA). Settlement takes place principally through the balancing of all receivables and liabilities at regular monthly intervals, which contributes to a significant reduction in the risk of non-payment and in the past stood at less than EUR 20m in a single month at the biggest partners. The maximum credit risk, albeit an unlikely one, includes trade receivables, securities and loans, as well as other current assets at the level of their book value. In individual cases, a separate security may be required in the particular payment agreement for other transactions, securities may be required or credit information/references obtained. Historical data from the business relationship up to that point, particularly in relation to payment behaviour, may be used in an effort to avoid non-payment. Recognizable risks are accounted for by valuation adjustments on receivables.

The credit risk from investments and derivative financial instruments arises from the danger of non-payment by a contractual partner. Since the transactions are concluded with contracting parties of the highest possible credit rating, the actual risk of non-payment is extremely low. Loans to contracting parties of less certain credit rating are only made if offset by assessable strategic advantages corresponding to the non-payment risk, or if securities are provided

# Liquidity Risk

Liquidity in the Group is protected on the one hand by appropriate liquidity planning and on the other through the financing structure, high financial stocks and sufficient short-term credit facilities. Around 80% of interest-bearing liabilities have a due date of more than one year. As at 31.12.2006, liquid funds in the broader sense, consisting of securities on assets, bank deposits and cash stocks, totalled approximately EUR 574.4m, of which EUR 501.5m was freely available. As a result of suitable investment strategies, only costs at a justifiable level can be allocated to the holding of liquidity. As at 31.12.2006, the agreed credit lines were almost entirely exhausted.

Concrete financing measures were already being prepared as at the balance sheet date for the aircraft deliveries due in 2007, to ensure that these investments could also be financed in the long term. Despite the investment additions of EUR 189.6m, which also include expenses for capitalized major repairs amounting to EUR 70.3m, and despite the negative result in 2006, interest-bearing liabilities fell by EUR 263.8m compared to the previous year.

# Effects of valuation of Cash Flow Hedges

- Future payment streams as a result of financial liabilities and future rental obligations from operating lease commitments are hedged against the risk of change in the interest rate and against currency risk. Only swaps concluded with international banks of first-class creditworthiness are used for this purpose. The swaps represent all OTC transactions. The hedging transactions extend over terms ranging from one year to nine years.
- The Group holds nine USD interest rate swaps, two JPY interest rate swaps and one CHF interest rate swap for the purpose of risk reduction from market rate behaviour
- In accordance with IAS 39, financial derivatives used to hedge the risks are reported in the balance subject to the Hedge Accounting regulations. In the area of Cash Flow Hedging, hedging transactions are valued at the Fair Value and the changes in value reported against the preceding period in the Cash Flow Hedge reserve (shareholders' equity) with no effect on profit. As at 31.12.2006, the value by which the shareholders' equity increased was EUR 1.8m. Proportional changes in volume or revaluations are then reported in or cancelled from the accounts on the balance sheet dates. EUR 28.9 (000) was rebooked from the Cash Flow Hedge reserve into the periodic result in the report period.

## Effects of valuation of Fair Value Hedges

- A liability bearing a fixed rate of interest is hedged against the Fair Value change by means of a swap. The only such swap used for this purpose was one concluded with an international bank of first-class creditworthiness. The swap represents an OTC transaction.
- Both basic and hedging transactions were valued at the Fair Value and the change in value reported against the preceding period via the Income Statement, having an effect on the result.
- The Group operates two currency swaps and one interest rate swap for the purpose of market value stabilization and comparability of ongoing payments..

# Embedded derivatives

In some financing, derivatives were incorporated into non-derivative basic contracts. In accordance with the provisions of IAS 39, these derivatives are classified as 'embedded derivatives' and valued with the basic contract on which they are based.

# Effectiveness measurement

The Group regularly measured the effectiveness of all its hedging transactions. Effectiveness was demonstrated in accordance with IAS 39 throughout the financial year 2006.



# Other derivatives

The Group holds ten foreign currency swaps for the purpose of reducing the risk from changes in foreign currency exchange rates.

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***THANK***

***YOU***

**CA, D.S.RAWAT**

**Partner, BANSAL & Co.**