

Financial Instruments – Recognition and Measurement

Section 3855

Background



- ◆ Filling the gap in GAAP
 - ◆ Bringing transparency to B/S and I/S
- ◆ Bringing Canada in line with US and Intl.

GAAP – no conflicts with US GAAP

Underlying principles



- ◆ Financial instruments (FIs) and derivatives recognized as assets and liabilities
- ◆ Fair value = most relevant for FIs and only relevant for derivative FIs
- ◆ Only report assets and liabilities as such
- ◆ Special accounting only for qualifying items

Applying the standard



Six steps:

1. Application to my entity
2. Identifying financial instruments
3. Classifying financial instruments
4. Recognizing financial instruments
5. Measuring financial instruments and recognizing gains and losses
6. Disclosure

Application to my entity

Step 1: Does it apply to my entity?

Answer: YES

- ◆ Applies to all entities – large & small, for profit & NFP, financial & non-financial, private & government business enterprises
- ◆ No scope exclusions by entity
- ◆ It doesn't matter what kind of entity you are - focus is on the financial instruments that you use

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Identifying financial instruments



Step 2: What financial instruments do I have?

Scope Exclusions:

- ◆ Subsidiaries, sig. infl. investees and JVs
- ◆ Leases
- ◆ Retirement benefits
- ◆ Stock-based payments
- ◆ Insurance contracts
- ◆ Specific guarantees
- ◆ Loan commitments

Identifying financial instruments

- ◆ Cash
- ◆ Trade receivables / payables
- ◆ Loans and notes receivable
- ◆ Long-term debt

Impact may not be significant

Identifying financial instruments

- ◆ Investments
 - ◆ Common shares
 - ◆ Debt
- ◆ Derivatives
 - ◆ Forwards
 - ◆ Swaps
 - ◆ Options

Impact probably more significant

Identifying financial instruments



- ◆ Commodity contracts covered, but exclude:
 - ◆ Commodities themselves (e.g., gold)
 - ◆ Commodity contracts where:
 - ◆ Delivery of the physical asset is expected
 - ◆ Meet expected usage requirements
 - ◆ No past practice of settling net, in cash or by entering into offsetting contracts, or asset to be delivered is readily convertible into cash

Identifying financial instruments



Embedded derivatives

Host contract + embedded derivative = hybrid

- ◆ Without requirements to bifurcate, could avoid requirements for some derivatives

Identifying financial instruments

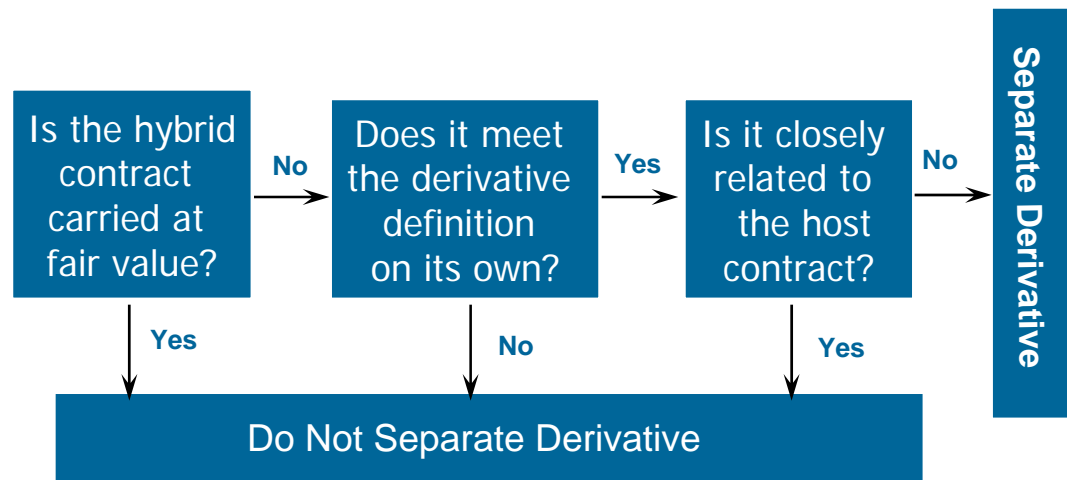


Embedded derivatives - examples

- ◆ Prepayment option in a mortgage or other financial instrument
- ◆ Convertible debt (debt with equity conversion option)
- ◆ Indexing features in loans or leases (e.g., linked to commodity prices or to CPI)
- ◆ Variable rate debt with caps or floors
- ◆ Indexing features in purchase/sale contracts

Identifying financial instruments

Embedded derivatives: Decision tree



Embedded derivatives: Accounting



- ◆ If the embedded derivative is required to be separated from host and can be identified and reliably measured
 - ◆ Host contract: apply applicable standard
 - ◆ Embedded derivative: apply FI standard (i.e., fair value in net income)
- ◆ If the embedded derivative cannot be identified and reliably measured
 - ◆ Account for the entire contract at fair value in net income

Embedded derivatives: Transition



- ◆ Recognize all embedded derivatives; or
- ◆ Select beginning of fiscal year ending no later than March 31, 2004 (e.g. Jan 1, 2003 for calendar year reporting)

IDENTIFY EMBEDDED DERIVATIVES NOW

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Classifying financial instruments



Step 3: Classify all financial instruments

Section 3855 defines 4 primary categories for assets:

- ◆ Held for trading (HFT)
- ◆ Held to maturity (HTM)
- ◆ Loans and receivables
- ◆ Available-for-sale (AFS)

Classifying financial instruments

Held for Trading (HFT)

MUST BE HFT IF:

- ◆ Acquired for selling or purchasing in near term
- ◆ Derivatives are always HFT (unless designated as hedging instruments or based on equity instrument that cannot be reliably measured)
- ◆ May also designate financial instrument as HFT on initial recognition (Not allowed in US)
 - ◆ Simplifies embedded derivatives & fair value hedges

Measured at fair value through net income

Classifying financial instruments:

Held to Maturity (HTM)

- ◆ Fixed maturity investments with fixed or determinable payments, that the entity intends and is able to hold to maturity

Measured at amortized cost

Classifying financial instruments:

Tainting HTM

- ◆ Generally, sales, or reclassifications in the previous 2 years on more than an insignificant amount of HTM securities prior to maturity cast doubt on intention to hold assets to maturity
- ◆ Impact - EVERY asset within the group must be reclassified out of HTM into AFS
- ◆ Some exceptions (e.g. out of entity's control)

Classifying financial instruments:

Loans and Receivables

- ◆ Financial assets resulting from delivery of cash or other assets by a lender to a borrower in return for a promise to pay other than:
 - ◆ Debt securities (incl. those quoted in an active market)
 - ◆ Designated as HFT
 - ◆ Designated as AFS
- ◆ Measured at amortized cost, regardless of intent
- ◆ No tainting

Classifying financial instruments:

Available-for-sale (AFS)

- ◆ Effectively a default classification
 - ◆ An asset that does not properly belong in the other categories
- ◆ Many equity investments likely to be classified here
- ◆ Measured at fair value – gains and losses in OCI (introduced by Section 1530) until asset sold, collected, or disposed of (except equity instruments with no quoted market value – at cost)

Classifying financial instruments:

Financial Liabilities

2 primary categories

- ◆ Held at cost / amortised cost (default category)
- ◆ Held for trading (HFT) – fair value through net income
 - ◆ Derivative liabilities
 - ◆ Short sales

Classifying financial instruments:

Re-classification

HFT

- ◆ No transfers in or out of HFT – must be designated on initial recognition
- ◆ Also rules for other reclassifications
 - ◆ Generally prospective application of effects of change

ADVANCE PLANNING ESSENTIAL

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Recognizing financial instruments



Step 4: Recognize financial instruments

- ◆ All financial instruments on the balance sheet
- ◆ Fair value on initial measurement
- ◆ Consequences for “off-market” transactions
- ◆ Related party transactions
 - ◆ Shareholder loans, etc.

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Measurement - summary

Step 5: Measure financial instruments and recognize gains and losses

	Categories	Measurement	Gains and losses
Assets	Loans and receivables	Amortized cost	Net income when asset is derecognized or impaired (foreign exchange and impairment recognized in net income immediately)
	Held-to-maturity investments		
	Available-for-sale financial assets	Fair value	Other comprehensive income (impairment recognized in net income immediately)
	Held for trading	Fair value	Net income immediately
Liabilities	Held for trading	Fair value	Net income immediately
	Other	Amortized cost	Net income when liability is derecognized (foreign exchange recognized in net income immediately)

Measuring financial instruments:

Determining fair value

- ◆ Active market prices
- ◆ Valuation techniques
 - ◆ Discounted cash flows
 - ◆ Models
 - ◆ Relatively straight-forward – e.g. option pricing
 - ◆ Complex

Measuring financial instruments:

Impairment



- ◆ Consider not only for those carried at cost / amortized cost, but also for AFS
- ◆ Consider indicators of impairment
- ◆ If so, consider whether other than temporary (significant or prolonged decline)
- ◆ If so, recognize impairment loss in net income

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Disclosure



Step 6: Disclosure in accordance with Section 3861

- ◆ Terms and conditions
- ◆ Use of financial instruments
- ◆ Measurement methods
- ◆ Etc.

Effective Date



- ◆ Mandatory – for interim & annual periods in years beginning on or after October 1, 2006
- ◆ Optional – years ending on or after December 31, 2004
- ◆ Text available since January 2005

**NOW IS THE TIME TO ASSESS THE
POTENTIAL IMPACT**

Transition

- ◆ Fresh start
 - ◆ No retroactive restatement
 - ◆ Reclassify financial assets and financial liabilities
 - ◆ Reallocate deferred gains and losses

Further information



- ◆ Background Information and Basis for Conclusions
- ◆ AcSB web site: www.acsbcanada.org
- ◆ Financial Instruments Working Group
(Contact Kate Ward 416-204-3437 or kate.ward@cica.ca)

****PLAN EARLY FOR IMPLEMENTATION****