

The New CICA Financial Instrument Standards: An Overview

December 2005

Introduction

In April 2005, the Accounting Standards Board (AcSB) issued CICA Handbook Section 3855, *Financial Instruments – Recognition and Measurement*, along with two companion standards, Section 1530, *Comprehensive Income*, and Section 3865, *Hedges*. These standards triggered nearly 100 pages of consequential amendments to other Handbook sections, including a new section on equity. They apply to all profit-oriented enterprises and, except for Section 1530, to all not-for-profit organizations. The sections are effective for years starting on or after October 1, 2006, but an entity can adopt them earlier if it wishes.

Many, if not most, will find the new requirements difficult to understand and challenging to apply. In this publication, we try to help you meet this challenge by providing an overview of the standards – a fly-over, if you will, at 100,000 feet. It is a measure of the comprehensive nature of the requirements that, even from this lofty height, our review needs more than 20 pages.

We summarize the major features of the standards on the following two pages. In later sections, we discuss certain aspects in more detail.

Contents

A Summary of What the New Standards Do	2
The Objectives of the Standards	4
How Entities are Affected	4
Comprehensive Income and Other Comprehensive Income	4
Basic Models of Accounting for Financial Assets and Liabilities	5
Non-Derivative Instruments	7
Derivatives	9
Embedded Derivatives	10
Initial Recognition of Financial Assets and Liabilities	11
Debt Issue and Other Transaction Costs	13
Interest Income and Expense	13
Impairments in Financial Assets	15
Financial Guarantees	16
Derecognition of Financial Liabilities	17
Scope	17
Hedging	19
Differential Reporting Options	20
Transition	20

A Summary of What the New Standards Do

The new rules:

- **Establish a new measure of income – comprehensive income.** Comprehensive income represents the entire change in the net assets of an entity for a period, other than changes attributable to transactions with owners. It has two components – net income and other comprehensive income (“OCI”). The latter represents gains and losses that must be recognized in a period but excluded from net income until some later date. An example of OCI is an exchange gain or loss arising from the translation of a net investment in a self-sustaining operation. An entity stores an item of OCI in a new account in shareholders’ equity, called “accumulated other comprehensive income”, until the entity transfers the item to net income. As we shall see, the concepts of comprehensive income and other comprehensive income play major roles in Sections 3855 and 3865.

- **Require an entity to account for certain financial assets and liabilities at fair value at each balance sheet date and allow the entity to use this basis of accounting for almost all other financial assets and liabilities.**

An entity must account for the following instruments at fair value:

- Financial assets or liabilities acquired for speculative purposes, other than loans or receivables;
- Investments in debt securities, except for those the entity intends to hold to maturity;
- Portfolio investments in equity securities quoted in an active market; and
- All derivatives, with one exception.

In some cases, changes in fair value go directly to net income. In other cases, an entity can put changes in OCI until the entity removes the instrument from the balance sheet or recognizes a loss as the result of impairment in a financial asset.

- **Define “derivative” for the first time and expand the concept to include certain non-financial items.** Any entity must apply this definition to all contracts on hand when it adopts the new rules as well to any contracts it enters into after that date. Beware! The definition captures not only contracts that everyone agrees are derivatives, such as interest rate swaps and foreign exchange contracts, but other contracts that most accountants usually do not regard as derivatives. For example, certain contracts for the purchase or sale of commodities or other non-financial items can qualify as derivatives.
- **Require an entity to account separately for certain derivatives embedded in non-derivative contracts.** Once an entity has identified which of its contracts are derivatives in their entirety, it then has to assess whether there are any derivatives embedded in its non-derivative contracts. If the economic risks and characteristics of an embedded derivative are not closely related to the rest of the instrument, it will be necessary to split the contract into two – a derivative and a non-derivative – and account for each as if it were a separate instrument. It’s possible to restrict the search for embedded derivatives to contracts entered into, acquired, or substantively modified subsequent to the beginning of any fiscal year ended no later than March 31, 2004. For example, an entity with a calendar year-end can choose to only evaluate contracts entered into, acquired, or modified after January 1, 2003.
- **Establish basic principles that determine when an entity should recognize a financial asset or liability on the balance sheet.** In large part, these principles codify existing GAAP, but there is potential for nasty surprises.

- **Prohibit accounting for debt issue costs as deferred charges.** An entity will have to expense these costs as incurred or, if certain criteria are met, net them against the carrying value of the debt. Similar principles apply for transaction costs incurred on the acquisition of financial assets or the issuance of other financial liabilities.
- **Prescribe a common method for calculating the effective interest rate on a debt and recognizing the effects of changes in cash flows on these instruments.** Under the new rules, the entity usually calculates the effective interest rate using its best estimate of cash flows and the expected life of the instrument rather than the contractual cash flows or contractual life of the instrument. This change primarily will affect debt instruments with prepayment, call, put or other similar features.
- **Establish a basic framework to recognize and measure impairments in financial assets.** This framework retains the existing rules for the recognition and measurement of impairments of trade receivables and loans. However, there have been some changes to the rules for investments that may accelerate the recognition of impairment losses for these instruments.
- **Require an entity to recognize a guarantee at its fair value when the entity becomes party to the contract.** Under existing GAAP, entities usually treat guarantees as contingencies that require accrual as a liability only if it is probable a payment will be required under the guarantee. Under the new rules, an entity usually must recognize a liability at its fair value at the date of its issue, regardless of the probability of payment. This is necessary even if the guarantee is part of a purchase, sale or other contract and the entity did not receive separate compensation for giving the guarantee. Conceptually, the fair value of a guarantee is the premium the entity would receive if it issued the guarantee in a stand alone transaction with an unrelated party.
- **Establish basic principles for determining when to derecognize a financial liability.** These principles mostly codify what's being done today.
- **Restrict the types of contracts that can be hedges and establish a new approach to hedge accounting.** Section 3865 tightens somewhat the rules for determining when an entity can use hedge accounting. The most significant change is that only derivatives can be hedges unless an entity is hedging a foreign currency exposure. In the latter case, the entity can use foreign currency denominated monetary items as hedges.
 - The type of hedge accounting that an entity must apply depends on the nature of the hedging relationship. For cash flow hedges, an entity must recognize gains and losses on hedging instruments in OCI until the hedged item affects net income. For fair value hedges, the entity recognizes gains and losses on the hedging item in net income when they arise, but adjusts the carrying value of the hedged item for changes in fair value attributable to the risk being hedged. For hedges of net investments in self-sustaining foreign operations, the entity follows the rules for cash flow hedges.
- **Require the recognition of hedge ineffectiveness in earnings when it arises.** Imperfections in a hedging relationship thus are sources of income statement volatility.

The Objectives of the Standards

The purpose of the new standards is to bring Canadian GAAP for the recognition and measurement of financial instruments, including hedging, broadly in line with US and international accounting standards. The remaining differences are often subtle, but still can be significant. These are beyond the scope of this document.

Adopting US and international GAAP on financial instruments is not a panacea. Many accountants view these standards as patchwork solutions that do not appropriately resolve fundamental issues affecting the recognition and measurement of financial instruments.

How Entities are Affected

How the standards will affect an entity depends on the types of financial instruments the entity has. Entities that hold only the most basic types of financial instruments, such as trade receivables and payables, may find that their financial statements are not much affected. In other situations, the impact of the new requirements can be significant. In particular, many entities will discover that reported income and shareholders' equity will be more volatile. This can have adverse impacts on debt covenants and other key financial statement ratios.

Entities often will find it is necessary to change information gathering and internal control systems to cope with the new requirements.

Comprehensive Income and Other Comprehensive Income

Section 1530 defines "comprehensive income" as the overall change in the net assets of an entity for a period, other than changes attributable to transactions with owners. Comprehensive income has two components – "net income" and "other comprehensive income". Net income has its usual meaning. OCI, a new term in Canadian GAAP, represents any gains or losses which GAAP requires to be recognized in a period, but excluded from net income for that period. A prime example of OCI is an exchange gain or loss arising from the translation of a net investment in a self-sustaining foreign operation. As we shall see, other gains and losses can qualify as OCI under Sections 3855 and 3865.

Accumulated other comprehensive income

Whereas net income winds up on the balance sheet in retained earnings, OCI ends up in a new shareholders' equity account called "accumulated other comprehensive income" ("AOCI"). In general, a gain or loss remains part of this balance until GAAP requires its recognition in net income. At that date, the entity transfers the gain or loss to the income statement with an offsetting adjustment to OCI for the period. To illustrate – assume an entity reports a gain of \$1,000 in OCI in Period One, but not in net income until Period Two. In Period One, OCI will increase by \$1,000. In Period Two, net income will increase by \$1,000 and OCI will decrease by \$1,000. Comprehensive income will increase by \$1,000 in Period One and be unaffected in Period Two.

Presentation in the financial statements

An entity must present comprehensive income and its components in a financial statement that has the same prominence as other financial statements. This can be accomplished in a variety of ways; e.g. providing a separate statement of comprehensive income, reconciling net income to comprehensive income at the bottom of the income statement, or including the reconciliation in the statement of shareholders' equity. In the US and other jurisdictions, entities usually follow the last approach. The appendix to Section 1530 contains an example of how an entity might present comprehensive income in its financial statements.

Basic Models of Accounting for Financial Assets and Liabilities

An entity must also present the cumulative individual components making up AOCI. These individual components may be presented in a note to the financial statements.

Under Section 3855, an entity must account for a financial asset or liability using one of three basic models:

Held for trading. Under this model, the entity measures a financial asset or liability at fair value at each balance sheet date. The entity recognizes changes in fair value in net income in the period in which the changes arise.

Cost. Under this model, the entity carries a financial asset or liability at its cost, or in the case of interest bearing instruments, at its “amortized cost”. At initial recognition, the cost of the instrument is its fair value, adjusted as appropriate for transaction costs. The entity accrues interest income and expense over the expected life of the instrument. It accrues dividend income when it acquires a right to receive the payment. The entity does not recognize gains and losses arising from changes in the fair value of an instrument until the gains and losses are realized, or there is impairment in the value of an asset. When recognized, such gains and losses are recorded directly in net income.

Available for sale. This model applies only to qualifying financial assets. Under this model, the entity measures a financial asset at fair value at each balance sheet date. However, it recognizes the related interest or dividend income, and any impairment losses, in the income statement as if the entity were accounting for the asset under the cost model. If a difference between the fair value of an available for sale asset and its cost basis arises in the period, the entity includes the difference in OCI rather than net income. Exchange gains and losses arising from the translation of monetary items denominated in a foreign currency are included in OCI as part of this difference (even though under the cost model, an entity recognizes these gains and losses directly in net income). The entity transfers differences accumulated in AOCI to net income when it removes the asset from the balance sheet, or has to recognize an impairment loss on the asset.

The held for trading and available for sale models always result in an entity carrying assets and liabilities in the balance sheet at fair value. It is therefore possible to describe both models as forms of “fair value accounting”. They differ only in that the trading model recognizes changes in fair value directly in net income when they occur whereas the available for sale model reflects these changes initially in other comprehensive income (other than the portion attributable to interest or dividends). Another way of expressing the difference between the two models is that unrealized gains and losses affect both net income and shareholders’ equity under the held for trading model, but only shareholders’ equity under the available for sale model.

For the purpose of applying the models, fair value has its usual meaning – the amount of consideration that would be agreed upon in an arm’s length transaction between knowledgeable, willing parties who are under no compulsion to act. As we shall see, this does not include transaction costs. Section 3855 provides detailed guidance on how to determine fair value in an appendix.

We caution you that while these models form the basis for the recommendations in the section, the recommendations themselves are not always expressed in these terms.

When each model applies

Under Section 3855, an entity often can choose which model to apply in accounting for a particular instrument. The following table provides a summary of the choices that are available. In the table, “Yes” in regular typeface means the entity can use the indicated model upon making a formal election. “Yes” in boldface means that the indicated model is the default model; that is, the entity can use the model without having to make a formal election. “No” means an entity cannot use the indicated model.

Elections are accomplished by designation. For example, an entity that wants to account for a loan or a receivable at fair value must designate the asset as held for trading or available for sale. Designations in every case can be made at the individual instrument level – there is no obligation to designate similar instruments the same way. This means, for instance, that an entity could account for some of its loans at amortized cost, others as trading, and still others as available for sale.

There are some restrictions on designations. In particular, an entity can designate an instrument as held for trading (or a loan or receivable as available for sale) only at the time of its initial recognition in the balance sheet. Moreover, once an entity designates an instrument as trading, the designation is irrevocable. Finally, an entity can elect to apply the held for trading model only if fair value can be measured reliably. An appendix to Section 3855 provides criteria for assessing whether an estimate of fair value is reliable.

Subject to these restrictions, an entity can account for almost every type of financial instrument at fair value. This reflects the view in Section 3855 that valuing financial assets and liabilities at fair value always provides more relevant information than valuing them at cost.

When fair value accounting is mandatory

Note from the table that an entity has to account for the following instruments at fair value, using either the held for trading or available for sale model, as appropriate. In effect, the presumption in the standards is that an entity always should be able to make a reasonable estimate of the fair value of these instruments.

- Speculative financial assets, other than loans or receivables;
- Investments in debt securities not classified as held to maturity investments;
- Portfolio equity investments quoted in an active market; and
- Derivatives, with one exception discussed below.

The section does not allow an entity to use cost to account for these instruments even if the cost of obtaining fair values is excessive.

Models of Accounting for Financial Assets and Liabilities

	Cost or amortized cost	Fair Value Basis	
		Available for sale	Held for trading
NON-DERIVATIVE INSTRUMENTS			
Speculative financial assets or liabilities			
• Loans and receivables	Yes	Yes	Yes ¹
• Other than loans or receivables	No	No	Yes
Non-speculative assets or liabilities			
• Loans and receivables	Yes	Yes	Yes ¹
• Investments in debt securities			
- Classified as held to maturity investments	Yes	Yes	Yes ¹
- Not classified as held to maturity investments	No	Yes	Yes ¹
• Portfolio equity investments			
- Quoted in an active market	No	Yes	Yes ¹
- Not quoted in an active market	Yes	No	Yes ¹
• Financial liabilities	Yes	No	Yes ¹
DERIVATIVE INSTRUMENTS			
• Derivatives that are linked to, and must be settled with, equity instruments of another entity whose fair value cannot be reliably measured	Yes	No	No
• Other derivatives	No	No	Yes
Note:			
<ul style="list-style-type: none"> • The table assumes the entity is not using hedge accounting. We discuss hedge accounting later. • There are special rules for instruments an entity acquires or originates in a related party transaction. In general, the entity first must measure a financial instrument in accordance with Section 3840, <i>Related Party Transactions</i>, and then apply Section 3855. 			
¹ An entity can choose to designate an instrument as held for trading only if the fair value of the instrument is reliably measureable.			

Non-Derivative Instruments

We set out below the criteria an entity should use to classify non-derivative financial instruments into the categories listed in the previous table.

Speculative financial assets and liabilities

We use the term “speculative financial assets and liabilities” to describe any non-derivative financial asset or liability that: (a) an entity acquires or incurs principally for the purpose of selling or repurchasing it in the near term; or (b) is part of a portfolio of identified financial instruments that are managed together, for which there is evidence of a recent actual pattern of short-term profit taking.

Determining whether an instrument falls into one of these categories requires judgment.

Loans and receivables

These are non-derivative financial assets (other than debt securities as described below) resulting from the delivery of cash or other assets by a lender to a borrower in return for a promise to repay on a specified date or dates, or on demand, and usually with interest. Trade accounts receivable generally fall within this category, even though they don't typically have a stated rate of interest.

When Section 3855 prescribes a particular treatment for loans and receivables, it generally is referring only to loans and receivables not designated as trading or available for sale.

Investments in debt securities

Section 3855 describes debt securities as non-derivative financial assets normally quoted in an active market. They include investments in government debt, corporate bonds, convertible debt, commercial paper, securitized debt instruments such as collateralized mortgage obligations and real estate investment conduits, and interest-only and principal-only strips.

Held to maturity investments

These are non-derivative financial assets with fixed or determinable payments and a fixed maturity that an entity has the positive intention and ability to hold to maturity. Because Section 3855 specifically excludes loans and receivables from this category and investments in equity securities have no maturity, only investments in debt securities can be held to maturity investments. Strict criteria have to be met before an entity can classify an investment as held to maturity. Moreover, actions such as selling a held to maturity instrument before its maturity can result in an entity "tainting" an existing portfolio of held to maturity investments. If this occurs, it will be necessary to account for the investments in the portfolio as available for sale or trading assets.

In general, when Section 3855 prescribes a particular treatment for held to maturity investments, it is referring only to those investments not designated as trading or available for sale.

Portfolio equity investments

Portfolio equity investments are investments in an equity instrument issued by another entity, other than investments in subsidiaries, joint ventures or equity accounted for companies. An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

An equity investment is "quoted in an active market" when quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency. Those prices reflect actual and regularly occurring market transactions on an arm's length basis. Thus, the concept of an active market, as defined in the standard, is far broader than an organized exchange, such as the Toronto Stock Exchange.

Available for sale assets

Available for sale assets are those non-derivative financial assets designated as available for sale or assets not classified as loans and receivables, held to maturity investments, or held for trading. The only assets that qualify as available for sale assets without being designated as such are investments in debt securities other than held to maturity investments, and portfolio equity investments. Under Section 3855, a portfolio equity investment not traded on

an active market technically qualifies as being “available for sale” even though it can only be accounted for using the cost or held for trading models.

Derivatives

Under Section 3855, an entity must measure a derivative at fair value at each balance sheet date (unless the derivative is linked to, and must be settled with, equity instruments of another entity whose fair value cannot be reliably measured). Unlike existing GAAP, fair value measurement is necessary even when the derivative qualifies as a hedge.

Key characteristics of a derivative

Section 3855 defines a derivative as any financial instrument or any other contract within its scope that has the following characteristics:

- Its value changes in response to a change in a specified interest rate, financial instrument price, commodity price, foreign exchange index of prices or rates, credit rating or credit index, or other variable, sometimes called the “underlying”. In the case of a non-financial variable, the variable is not specific to a party to the contract.
- It requires no initial net investment or an initial net investment smaller than that required for other types of contracts expected to have a similar response to changes in market conditions.
- It is settled at a future date.

As most contracts are settled at a future date and many have a value that will change in response to a specified variable, the requirement for an initial net investment is often the thing that determines if a contract is a derivative. Broadly speaking, a contract has this characteristic if it creates an exposure to changes in the fair value of an asset without requiring an upfront payment equal to the amount necessary to purchase the asset. For example, a debt does not qualify as a derivative because the underlying agreement requires the creditor to make an investment at the inception of the debt equal to fair value of the debt. By contrast, an interest rate swap that has a notional principal amount equal to that of the debt is a derivative because the parties to the agreement participate in changes in the fair value of the debt without either party making an upfront investment.

Scope exclusions

Section 3855 excludes the following contracts from its scope even though they exhibit all of the characteristics of derivatives:

- Most insurance contracts.
- Contingent consideration in a business combination.
- Contracts requiring payments based on climatic, geological or other physical variables and that are neither traded on an exchange nor held for trading.
- Contracts that require a payment based on a non-financial asset or liability of one of the parties to the contract, provided that the contract is not traded on an exchange and the asset is not readily convertible to cash.
- Contracts that require a payment based on specified volumes of sales or service revenues of one of the parties to the contract and that are not traded on an exchange.
- Certain commitments to issue loans that cannot be settled in cash or another financial instrument.

Contracts for the purchase or delivery of non-financial items

Section 3855 includes certain derivative non-financial instruments within its scope. Any contract for the purchase or delivery of a non-financial item is subject to the standard, and likely will qualify as a derivative, if it has the following characteristics:

- The contract can be “settled net”; and
- Either the price of the non-financial item is based on a variable that is not closely related to the item being purchased or delivered, or the entity is holding the contract for a purpose *other than* receipt or delivery of the item in accordance with its expected purchase, sale or usage requirements.

A contract can be settled net if either party can participate in the changes in the value of the non-financial item that is the subject of the contract without actually having to make or take delivery of the item. Also, contracts that do not carry an explicit right of net settlement are deemed to be capable of net settlement if: (a) the non-financial item that is the subject of the contract is readily convertible to cash; (b) the entity has a practice of settling similar contracts net (whether with the counterparty, by offsetting the contract against another, or selling the contract before its exercise or expiry); or (c) for similar contracts, the entity has a practice of taking delivery of the item and selling it within a short period to generate a profit from short-term fluctuations in price or dealer’s margin.

Documentation requirements

Section 3855 states that an entity documents the basis for concluding that the purpose of a contract is for receipt or delivery of a non-financial item in accordance with its expected purchase, sale or usage requirements. The documentation may be applied either to groups of similar contracts or to each individual contract. We understand this statement to mean that absent such documentation, an entity cannot say that it is holding a contract for receipt or delivery in accordance with its expected purchase, sale requirements. For some contracts, therefore, the failure to document means the contract will be a derivative.

Some contracts that do not qualify as derivatives in their entirety may have certain terms that act like derivatives. For example, assume an entity issues a debt where the payments are based on the price of a commodity. The entity is in the same position as if it had issued a debt requiring fixed payments and a commodity swap where the entity receives fixed payments and a floating payment based on the price of the commodity.

Under Section 3855, an entity has to account for a derivative instrument embedded in a non-derivative contract separately from the remainder of the contract (referred to in Section 3855 as the “host” contract), unless either of the following conditions is met:

- The economic characteristics and risks of the derivative are closely related to its host; or
- The entity already is accounting for the contract at fair value and recognizing changes in fair value in net income as they arise, i.e. the instrument is held for trading.

Determining whether an embedded derivative is closely related to a host contract requires judgment. Section 3855 provides examples of contracts that require separation of embedded derivatives as well as those that do not. The following table lists some of the more common ones.

Examples of Embedded Derivatives

REQUIRING SEPARATION	NOT REQUIRING SEPARATION
<ul style="list-style-type: none"> • Certain debts where interest payments are based on a multiple of a market interest rate. • Equity or commodity indexed interest or principal debt payments. • From a debt holder's perspective, a debt convertible into equity of the issuer. • An option in a debt giving the holder the right to put the debt to the issuer for an amount based on a change in an equity or commodity index. • A call, put, surrender or prepayment option when the exercise price does not approximate the debt's amortized cost at each possible exercise date. • An option to extend the term of a debt at a rate that is fixed at inception. • Credit derivatives with payments referenced to an item other than the debt itself. 	<ul style="list-style-type: none"> • Price adjustment clauses based on prices or indices closely related to the contract. • Embedded floors or caps of interest rates in a debt instrument unless in the money at issue. • Contingent lease rentals based on related sales. • Unlevered inflation indexed lease payments. • Credit derivatives with payments that depend on the credit risk of the issuer. • A foreign derivative in a contract for the purchase or sale of a non-financial item that either is priced in the functional currency of one of the parties or in a currency routine in international commerce for such items, unless the contract is leveraged or contains an option feature.¹
<p>¹ Alternatively, If the currency in which the contract is denominated requires an entity to separate an embedded foreign currency derivative, the entity may choose, as a matter of accounting policy, not to separate the derivative if the contract requires payment denominated in a currency that is commonly used for such contracts in the economic environment in which the transaction occurs.</p>	

If an entity is unable to reliably determine the fair value of an embedded derivative that requires separation, the entire contract containing the embedded derivative is marked-to-market with changes in fair value flowing through net income.

Initial Recognition of Financial Assets and Liabilities

So far, we have reviewed the basic accounting models an entity can apply in measuring financial instruments and derivative non-financial instruments. We have not, however, discussed the criteria that an entity should apply in determining when to initially recognize a financial asset or liability on its balance sheet.

Section 3855 establishes the basic principle that an entity should recognize a financial asset or liability when, and only when, the entity becomes a party to the contractual provisions of the instrument. While this principle seems straightforward, it can have surprising consequences for measuring the cost basis of financial assets and liabilities acquired or issued under forward contracts. To illustrate – assume an entity enters into a contract to acquire an

investment in common shares in six months for \$1,000 to be paid on the delivery of the shares. The shares are not quoted on an active market and the entity determines that it will account for the investment at cost. Upon acquisition, six months later, the shares have a fair value of \$1,500.

Earlier, we explained that under the cost basis of accounting, the cost of a financial asset is its fair value at the date of its initial recognition in the balance sheet. Therefore, in our example the entity must record the shares at their fair value of \$1,500, even though the entity only paid \$1,000 to acquire them.

Why is it appropriate to say that the cost of the shares is \$1,500? The explanation lies in the fact that the entity entered into a forward contract to acquire the shares. The contract itself is a financial instrument. Under Section 3855, the entity must account for the contract as well as the shares. The forward contract qualifies as a derivative and, as we have discussed, always must be measured at its fair value. At its settlement, the contract is worth \$500 – the entity has to pay only \$1,000 to receive shares worth \$1,500. Thus, at the date the entity actually acquires the shares, the carrying value of the contract is \$500. For accounting purposes, therefore, the entity is giving up two assets to acquire the shares – the cash worth \$1,000 and a contract worth \$500. Hence, the cost of the shares is \$1,500.

In some cases, it may be possible to fix the cost of the shares at \$1,000 using hedge accounting.

Regular way contracts

Section 3855 provides a simpler approach for “regular way” purchases of financial assets as an alternative to the approach described above. Regular way purchases are forward contracts for purchase whose terms require delivery of the asset within the time frame established by regulation or convention in the market place. The time frame of such contracts generally is very short – a matter of days. A typical example of a regular way purchase is the acquisition of shares from a broker under a contract that settles in three days.

In a regular way purchase, an entity must use one of two methods – either “trade date” or “settlement date” accounting.

Under trade date accounting, the entity recognizes the purchase price of the asset at the date it commits to purchase the asset (“the trade date”) by setting up an asset and a liability at an amount equal to the contract price.

Under settlement date accounting, the entity recognizes the purchase of the asset on the date the entity receives the asset (“the settlement date”). If the entity accounts for the asset at cost or amortized cost, the entity simply records the asset and its liability to pay for it at the contract price. However, if the entity accounts for the asset as a trading or available for sale asset, the entity must recognize any change in the fair value of the asset between the trade date and the settlement date. It does this by setting up a receivable or a payable and adjusting net income or other comprehensive income, as appropriate. The entity then records the asset at its fair value at that date and the liability to pay for it at the contract price, and eliminates the receivable or payable.

The seller in a regular way transaction applies the same principles. A useful example of trade date and settlement date accounting for the purchaser and seller is provided in Section 3855.

Debt Issue and Other Transaction Costs

Once an entity adopts Section 3855, the entity cannot account for debt issue costs as a deferred charge and present them as a separate asset in the balance sheet. If the entity is accounting for the debt on the cost basis, the entity must either expense transaction costs as incurred or add them to the carrying value of a debt. The treatment is a matter of accounting policy. If the entity is accounting for the debt as trading, it must expense the costs as incurred. The same principles apply in accounting for transaction costs relating to the acquisition of financial assets or other financial liabilities.

What about costs relating to available for sale assets? Technically, an entity can either expense or capitalize these costs. However, if an entity selects the capitalization option, it will have to write the costs off, to OCI, immediately after capitalization. This is necessary because the entity always has to measure an available for sale asset at its fair value.

Interest Income and Expense

Section 3855 requires an entity to recognize interest income and expense on the following instruments, assuming the entity accounts for them using the cost or available for sale models:

- Loans and receivables;
- Investments in debt securities; and
- Financial liabilities.

Under the held for trading model, an entity recognizes changes in fair value of an instrument in net income as they arise. Section 3855 does not address the issue whether an entity can present the portion of the change in fair value attributable to interest separately in the income statement.

Calculating interest income or expense and amortized cost

An entity determines the amount of interest income or expense to recognize in a period by multiplying the “amortized cost” of the instrument at the beginning of the period by its “effective interest rate”.

The amortized cost of an instrument at any point in time represents the amount the entity assigned to the instrument at initial recognition minus principal repayments, plus or minus the cumulative amortization of any difference between the initial amount and the maturity amount of the instrument. The amortized cost of financial assets is also net of any impairment writedowns or allowances.

Section 3855 provides detailed guidance on how to amortize differences between the initial recognition amount and its maturity amount. Such differences can arise from transaction costs applied against the carrying value of the debt, the issuance or purchase of instruments with off-market coupon rates, or other factors. As a general rule, the aggregate amortization in any period for all such differences will be the amount necessary to adjust the cash interest receivable or payable for the period to the amount of interest income or expense determined for the period.

The effective interest rate

The effective interest rate of an instrument is the rate that exactly discounts estimated future cash payments or receipts to the net carrying amount of the instrument through the expected life of the instrument (or shorter period if appropriate).

In estimating future cash flows, an entity should take into account contractual terms that could cause cash receipts or payments to vary, including prepayment, call, put or other options. However, the entity should assume both parties to the instrument perform their obligations in accordance with the instrument. The only exception to this rule arises when the entity has acquired a loan at a deep

discount that reflects expected or incurred credit losses. In this case, the entity should consider these credit losses in making cash flow estimates. The entity will recognize credit losses not anticipated at acquisition by recording an impairment loss. We discuss impairments in the following section.

In estimating future cash flows, the entity should be sure that the factors causing cash receipts or payments, or the expected life of the instrument to vary, do not represent embedded derivatives that have to be separated from the instrument and accounted for at fair value (see “Embedded Derivatives” above).

In those rare cases where an entity cannot reliably estimate the future cash flows or the expected life of an instrument, it should determine the effective interest rate using the contractual cash flows over the full contractual term of the instrument.

Adjusting the effective interest rate or the amortized cost

Except as indicated below, an entity determines the effective interest rate of an instrument only once, at the date of its initial recognition on the balance sheet. If the entity changes its estimate of future cash flows or the expected life of the instrument, it accounts for the changes by adjusting the amortized cost of the instrument so that it equals the present value of the revised cash flows discounted at the instrument’s original effective interest rate. An entity must re-estimate cash flows and their timing every period and recognize the effect of any changes through net income in the period of the change.

There is an exception to this principle for floating rate loans. An entity adjusts the effective interest rate on these loans for changes in estimates of cash flows arising from changes in market rates of interest. To illustrate – assume an entity issues a one year loan at the BA rate plus 2%, where the interest rate is reset at the start of each quarter. The loan is issued at par and there is no difference between the initial amount recognized for the loan and its maturity amount. At initial recognition, the BA rate is 3%, which ordinarily will result in an effective interest rate on the loan for the next quarter of 5%. At the end of the first quarter, the BA rate is 4%, which ordinarily will result in an effective interest rate of 6% for the following quarter.

An entity also adjusts the effective interest rate when an asset or liability qualifies as the hedged item in a fair value hedge. We discuss this later.

Under existing GAAP, the computation of the effective interest rate varies depending on the asset or liability in question. Sometimes the computation is based on the contractual cash flows and life, adjusting it for factors such as costs and premiums and discounts. In other situations, the entity will use cash flows for a shorter period; for example, if the holder has the right to put an instrument back to the issuer at a date earlier than its maturity.

Interest income or expense for a group of loans

The effective interest method can be applied on an individual or group basis.

Impairments in Financial Assets

In applying the cost and available for sale models to financial assets, Section 3855 requires an entity to consider whether there is objective evidence that indicates that an asset is impaired at each balance sheet date. If such evidence exists, the entity must decide whether recognition of an impairment loss is appropriate.

Criteria for recognition and measurement of impairment losses

The criteria to apply in recognizing and measuring impairment losses depend on the type of asset being assessed. We set out these criteria, and the Handbook Section that governs their application, in the table below.

Financial Assets – Impairment Criteria

Asset	Applicable Handbook Section	Recognition Criteria	Measurement Criteria
Short-term trade and notes receivable	S.3020	Entity expects to incur losses in future on collection	Expected amount of future losses.
Loans	S.3025	Entity no longer has reasonable assurance of collection of principal and interest in accordance with loan agreement.	Generally, the amount by which the cost basis of the asset exceeds the present value of expected future receipts, discounted at loan's effective interest rate.
Investments in debt securities and equity securities	S.3855	The decline in fair value that is other than temporary.	Generally, the amount by which the cost basis of the asset exceeds its fair value.
Other financial assets (e.g. derivatives at cost)	S.3855	The decline in fair value that is other than temporary.	Generally, the amount by which the cost basis of the asset exceeds its fair value.

Section 3855 did not modify Section 3020 or 3025 other than to align the definition of the effective interest rate in Section 3025 to that in Section 3855.

Criteria relating to the recognition and impairments of financial assets other than loans and receivables are now found in Section 3855. The section retains the principle in existing Handbook Section 3050 that it is appropriate to recognize an impairment loss only when it is "other than temporary". However, it does not carry forward the presumption in Section 3050 that recognition of a loss is appropriate if an impairment condition persists for three or four years. Practice often has interpreted this to mean that recognition of an impairment loss must be delayed until such a lengthy period had elapsed. We expect the elimination of this presumption will accelerate the timing of impairment recognition on investments. Note also that the Accounting Standards Board

Financial Guarantees

has announced that it will be providing additional guidance on the recognition of “other than temporary” impairments.

For investments in debt and equity securities or other financial assets, when an entity determines that a decline is other than temporary, it must recognize an impairment charge equal to the full difference between the fair value of the asset and its cost basis. It is not possible to take a lesser impairment charge even if the entity anticipates the value of the asset will partially recover.

Assets accounted for at cost

Under the cost model, an entity recognizes an impairment loss in the traditional fashion, i.e. writing down the asset or establishing an allowance for impairment and charging net income.

Available for sale assets

Recall that under the available for sale model, an entity measures an available for sale asset at its fair value and accumulates differences between the fair value and the cost of the basis of the asset in AOCI. Accounting for an impairment loss under this model depends on whether the asset in question is a loan or receivable or other type financial asset.

For a financial asset other than a loan or receivable, an entity recognizes an impairment loss by transferring an appropriate amount from AOCI to net income. For loan or receivable, the entity recognizes the loss directly in net income, by writing down the asset or setting a valuation allowance against the asset in accordance with Section 3020 or 3025, as appropriate. However, as this may not result in the asset being carried at its fair value at the balance sheet, a compensating adjustment to other comprehensive income to bring the asset to its fair value also may be necessary.

Section 3865 requires an entity to recognize a liability for any guarantee that falls within the scope of the section at its fair value at the date of initial recognition. How the liability arises does not matter. For example, an entity must set up a liability for guarantees embedded in a purchase or sale agreement or other contract. Under existing GAAP, an entity usually does not recognize a liability for a guarantee at initial recognition unless it prices and sells the guarantee separately; i.e., the entity receives a separate premium for giving the guarantee. In other cases, liability recognition often is postponed until it is likely that the entity will have to make a payment under the guarantee.

Fair value at initial recognition

The fair value of a guarantee ordinarily will be equal to the premium the entity receives for giving the guarantee. If an entity did not receive a premium, it will have to estimate what the premium would be, assuming the guarantee arose in a stand alone transaction with an unrelated party. Section 3855 also states that if a guarantee is a contingency subject to Section 3290, the amount to be recognized equals the greater of its fair value or the amount that would be set up under Section 3290.

After initial recognition

Section 3855 does not apply to the measurement of guarantees subsequent to initial recognition, unless the guarantee qualifies as a derivative; that is, the guarantee is one where the payment to the guarantor depends on a change in a specified financial variable, or a change in a non-financial variable not specific to a party to the guarantee. Examples of such financial variables include an interest rate, financial instrument or commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index.

Scope exemptions

Section 3855 applies only if a guarantee qualifies as a financial liability. This means, for example, that a guarantee that provides for settlement by the provision of services is not subject to the section.

The section also excludes the following financial guarantees from its scope:

- Guarantees issued either between a parent and its subsidiary or between entities under common control; guarantees by a parent of its subsidiary's debt to a third party; and guarantees by a subsidiary of debt owed to a third party by either its parent or another subsidiary of that parent;
- Guarantees that are specifically excluded from the scope of AcG 14; and
- Guarantees that qualify for exclusion under one of the more general scope exceptions in Section 3855 (see "Scope").

Guarantees specifically excluded from the scope of AcG 14 include product warranties and vendor rebates. An example of a guarantee that is not subject to Section 3855 because it fits one of the more general scope exceptions in Section 3855 is a guarantee of a debt to a lender that provides for a payment only upon the event of default by the borrower and the incurrence of a loss by the lender. This guarantee qualifies for the "insurance contract" scope exemption in Section 3855.

Derecognition of Financial Liabilities

Section 3855 establishes the general principle that an entity should derecognize a financial liability when, and only when, the entity extinguishes the liability (i.e. when the obligation specified in the contract is discharged, cancelled or expires). When this occurs, the entity includes any difference between the carrying amount of the liability and the consideration in net income.

The section also carries forward the guidance in EIC 88 which discusses when a modification of exchange of debt instruments should be considered to be an extinguishment of that debt. It also ends, once and for all, the debate whether an in-substance defeasance is an extinguishment – it is not.

Scope

Subject to the scope exceptions below, Section 3855 applies to:

- Any instrument that meets the definition of a financial asset or financial liability; and
- Certain contracts for the purchase or sale of non-financial items – see "Derivatives".

Definition of financial assets and liabilities

Section 3855 defines financial assets and liabilities the same way as existing Section 3860. A financial asset is any asset that is cash, a contractual right to receive a financial asset from another party, a contractual right to exchange financial instruments with another party under conditions that are potentially favourable to the entity; or equity instrument of another entity. A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another party; or exchange financial instruments with another party under conditions that are potentially unfavourable to the entity.

Scope exceptions

We list the specific scope exceptions in Section 3855 in the following table.

Scope Exceptions under Section 3855

- Equity instruments issued by the entity.
 - Interests in subsidiaries, joint ventures and entities subject to significant influence accounted for under Sections 1590, 3051, 3055 and AcG 15.
 - Lease contracts subject to Section 3065, except for any derivatives embedded therein. In addition, the impairment provisions of Section 3855 apply to lessor's receivable under a direct financing or sales-type lease and the derecognition provisions of that section apply to a lessee's capital lease liability.
 - Employee future benefits accounted for by an employer under Section 3461.
 - Contracts issued to policyholders by insurance enterprises accounted for under Section 4211 or AcG 3, other than freestanding derivatives.
 - Insurance contracts, as defined, held by policyholders, other than derivatives embedded in insurance contracts held by policyholders.
 - Investments accounted for at fair value by an investment company under AcG 18 and assets held in segregated accounts of life insurance enterprises accounted for at market under Section 4211. Recognition, regular-way purchase or sale, and fair value measurement considerations, however, do apply to these investments.
 - Stock-based compensation accounted for under Section 3870, other than contracts within the scope of paragraphs .14-.17 in which the entity obtains goods or services.
 - Certain guarantees – see earlier discussion under “Financial Guarantees”.
 - Contracts issued by the entity for contingent consideration in a business combination.
 - Contracts requiring payment based on a climatic, geological or other physical variable and that are neither traded on an exchange nor held for trading, except for any derivatives embedded therein.
 - Contracts not traded on an exchange and requiring payment based on the price or value of a non-financial asset of one of the parties. The asset must not be readily convertible to cash, or a non-financial liability of one of the parties, provided the liability does not require delivery of an asset readily convertible to cash.
 - Contracts requiring payment based on specified volumes of sales or service revenues of one of the parties and are not traded on an exchange.
 - Commitments to originate loans that cannot be settled net in cash or another financial instrument, except those designated as held for trading. An entity with a past practice of selling assets that have resulted from its loan commitments shortly after origination applies the section to all of its loan commitments in the same class.
 - Derivatives, whether free-standing or embedded, whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty.
-

Hedging

Hedge accounting is a special GAAP override under which an entity modifies the timing of recognition of gains and losses on the hedged item, or the hedging item, so that gains and losses on both are recognized in net income in the same accounting period. Section 3865 addresses the following two questions relating to hedge accounting:

- What criteria does an entity have to meet in order to apply hedge accounting?
- How does hedge accounting work after the entity adopts Section 3855? In other words, where do the debits and credits go?

The criteria for applying hedge accounting

Section 3865 carries forward most of the criteria for hedge accounting established a few years ago by AcG 13, *Hedging Relationships*. However, there are some modifications. Perhaps the most significant one is that an entity cannot designate an item other than a derivative as a hedging instrument unless the entity is hedging a foreign currency risk. In that case, the entity can also designate a monetary item denominated in a foreign currency as the hedging item.

Applying hedge accounting

The accounting for a particular hedging relationship depends on its nature:

Fair value hedges. Fair value hedging applies when an entity is hedging the change in fair value of an existing asset or liability, or firm commitment attributable to a particular risk. Under this model, an entity recognizes gains or losses on the hedging item in net income as if hedge accounting did not exist. Instead, the entity adjusts the carrying value of the hedged item up or down to recognize the gain or loss attributable to the hedged risk. This is done by adjusting net income up or down. If an entity is accounting for the hedged item at amortized cost, the entity must amortize the adjustment to net income by recalculating the effective interest rate for the instrument. Amortization can start as soon as an adjustment occurs, but the entity can defer amortizing the adjustment until the entity ceases hedge accounting.

Cash flow hedges. Cash flow hedging applies when an entity hedges the variability in cash flows attributable to a particular risk. This variability may arise from an existing asset or liability (e.g. a floating rate debt), or an anticipated transaction (e.g. an anticipated sale denominated in a foreign currency). Under this model, the entity recognizes gains and losses on a hedge, to the extent it is effective, in OCI until the hedged item affects earnings.

Hedge of a net investment in a self-sustaining foreign operation. This applies when an entity hedges exchange gains and losses arising from the translation of a net investment in a self-sustaining foreign operation. The accounting for gains and losses on the hedging item is the same as for cash flow hedges.

Hedge ineffectiveness

Hedge ineffectiveness arises whenever changes in the fair value or cash flows of the hedged item do not exactly offset changes in the fair value or cash flows of the hedging item during a period. This will occur whenever the hedged item and the hedging item are not perfect matches. Under Section 3865, an entity recognizes hedge ineffectiveness in net income when it arises. Under existing GAAP, an entity usually recognizes only indirectly, when the hedged item affects earnings.

Differential Reporting Options

There is only one new differential reporting option available under the new standards. Under Section 3855, an entity that qualifies for differential reporting can elect to account for certain available for sale assets at cost or amortized cost instead of at fair value. This option applies only to available for sale assets that do not have a quoted market price in an active market or that are not designated and effective as hedging instruments. Usually, this option is relevant only in the case where a differential reporting entity holds investments in debt securities not quoted in an active market.

Transition

Section 1530 applies to all profit-oriented enterprises. Sections 3855 and 3865 apply to all entities, including not-for-profit organizations.

The sections apply to interim and annual financial statements for fiscal years beginning on or after October 1, 2006. An entity can apply the standards earlier, as of the start of a fiscal year beginning after December 31, 2004, but only if the entity adopts the standards in the first quarter. Sections 1530, 3855 and 3865 are a boxed set – an entity cannot adopt one of these sections without also adopting the others.

The principal transition requirements are as follows:

Section 1530

- An entity must restate comparative financial statements, but only for gains and losses arising from the translation of self-sustaining foreign operations, appraisal increase credits and, unless impracticable, donations from non-owners. Restatement typically involves reclassifying amounts included in the cumulative translation adjustment account in shareholders' equity to AOCI.

Section 3855

- An entity cannot restate comparative financial statements.
- At the beginning of the fiscal year when the entity first applies the section, the entity must recognize all financial assets and liabilities on its balance sheet in accordance with the section. An entity may designate instruments as being held to maturity, trading or available for sale at this date.
- An entity remeasures any financial instruments to comply with the section. It recognizes any adjustments by restating the opening balance of retained earnings, except for financial assets, which are classified as available for sale. It includes adjustments relating to these instruments in the opening balance of AOCI.
- An entity has the option of recognizing all embedded derivatives for which Section 3855 requires separate accounting, or only those embedded in instruments issued, acquired or substantively modified on or after a selected transition date. This date may be the beginning of any fiscal year ended no later than March 31, 2004. For example, a company with a calendar year end could limit its search for embedded derivatives to instruments issued, acquired or modified after January 1, 2003.
- If an entity has previously recognized gains and losses at the inception of a contract using a fair value measurement technique not consistent with the requirements of the section, an entity can elect to apply the requirements of the new section only to contracts entered into after October 25, 2002, or all new contracts after the section is initially applied.
- There are certain disclosure requirements for transitional provisions.

Section 3865

- An entity does not reverse the effects of hedge accounting policies applied in financial statements for prior periods. It cannot restate comparative financial statements and cannot retroactively designate as hedges transactions entered into before the beginning of the fiscal year in which the entity first applies Section 3865.
- There is no grandfathering of pre-existing hedging relationships. An entity must ensure these relationships qualify for hedge accounting under Section 3865 to continue to apply hedge accounting.
- At the beginning of the fiscal year in which the entity first applies the section, it adjusts:
 - The carrying value of a hedging item in a fair value hedge to its fair value; and
 - The carrying value of the hedged item to reflect changes in fair value attributable to the hedged risk. The adjustment is the lesser of the cumulative changes in the fair value of the hedged item attributable to the hedged risk and the cumulative amount of the change in the fair value of the hedging instrument.
- Except as noted below, the entity recognizes adjustments to carrying values in the opening balance of retained earnings at the beginning of the year in which it initially applies the section.
- If under its previous accounting policy an entity has deferred gains and losses on cash flow hedges, the entity reclassifies any such amounts at the beginning of the year in which it applies the section. The reclassification is to AOCI to the extent the amounts qualify for inclusion in this category under Section 3865. Any remainder goes to retained earnings.

We expect additional guidance will be issued which clarifies the application of the transitional provisions.

Contacting Us

We would be pleased to answer any questions you have about this publication. You can contact your local engagement partner or, if you prefer, the following financial instrument experts in our National Risk and Quality office:

Scott Bandura	416 941 8432	scott.a.bandura@ca.pwc.com
Gord Cetkovski	416 814 5716	gord.cetkovski@ca.pwc.com
Larissa Dyomina	416 869 2320	larissa.dyomina@ca.pwc.com
Robert Marsh	416 941 8214	robert.marsh@ca.pwc.com
James Saloman	416 941 8249	james.s.saloman@ca.pwc.com

www.pwc.com/ca