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Changes to Section 3855 Affecting the Accounting for Investments in Debt Securities and Loans and Receivables

In August 2009, the Accounting Standards Board (the "AcSB") amended the requirements in Section 3855, *Financial Instruments – Recognition and Measurement* ("Section 3855") on accounting for investments in debt securities, such as government debt, corporate bonds, convertible debt, commercial paper, certain in-substance debt instruments such as term preferred shares, and securitized debt instruments. There have been consequential amendments to other aspects of Section 3855 that can affect the accounting for certain types of loans and receivables.

In this memorandum, we address frequently asked questions that have arisen in connection with the interpretation and application of these amendments for those entities that account for investments under Section 3855.

HIGHLIGHTS

The AcSB amendments:

- Change the definition of loans and receivables to include certain investments in debt securities and exclude any loan or receivable acquired for trading purposes.
- Relax the rules for measuring investments in debt securities at amortized cost. Under old Section 3855, an investment in a debt security could be accounted for at amortized cost only if the investment qualified as a Held-to-Maturity ("HTM") asset. Under the new rules, investments in debt securities may be accounted for at amortized cost even if an entity does not have the positive intention and ability to hold the investment until maturity provided the investment qualifies for classification as a loan and receivable.
- Amend the definition of Held-for-Trading ("HFT") to include loans and receivables acquired for trading purposes. Under old Section 3855, entities were not required to include loans in this category even if they were held for trading purposes.
- Change the impairment rules for investments in HTM debt securities. Under old Section 3855, it was necessary to recognize an impairment loss in a HTM investment if there was objective evidence of impairment and there was a decline in the fair value that was other than temporary. Under new Section 3855, impairments in HTM securities are recognized and measured on the same basis as loans and receivables; i.e. impairments are recognized when the entity no longer has reasonable assurance of timely collection and measured based on the present value of expected future cash flows discounted at the original effective interest rate.
- Leave intact the existing requirements for the recognition and measurement of impairments in investments in Available-for-Sale ("AFS") debt securities but now require the reversal of an impairment loss if their fair value subsequently recovers, provided the recovery can be related to objective evidence of an event occurring after the loss.
- On transition, permit the transfer of eligible investments in debt securities to HTM or loans and receivables categories.
- Apply to annual financial statements relating to fiscal years beginning on or after November 1, 2008. Earlier adoption is permitted for interim financial statements issued on or after August 20, 2009.

THE REASON FOR THE AMENDMENTS

1. Why were the amendments to Section 3855 made?

Accounting for investments in debt securities under Section 3855, *Financial Instruments – Recognition and Measurement* ("Section 3855"), initially was harmonized with US GAAP. In April 2009, however, the FASB amended its guidance causing differences between Section 3855 and US GAAP in this area to widen. In light of Canada's transition to the International Financial Reporting Standards (the "IFRS"), the AcSB decided to bring the relevant guidance in Section 3855 closer to its IFRS counterpart, IAS 39, *Financial Instruments: Recognition and Measurement* ("IAS 39") rather than adopt the US GAAP amendments.

THE AMENDED CLASSIFICATION REQUIREMENTS

2. What financial instruments now qualify as loans and receivables?

Under the amended definition in Section 3855, non-derivative financial assets with fixed or determinable payments that are not quoted in an active market qualify as loans and receivables, except for those:

(i) The entity intends to sell immediately or in the near term, which are classified as held-for-trading, and those that the entity, upon initial recognition, designates as held-for-trading;

(ii) The entity upon initial recognition voluntarily designates as available-for-sale; or

(iii) Where the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which are classified as available-for-sale.

3. Can an investment in a debt security be classified as a Loan and Receivable under the amended definition?

Yes, provided it is not quoted in an active market and is not excluded under criteria (i), (ii) or (iii) outlined in question 2 above.

4. What does "quoted in an active market" mean?

Section 3855 states that a financial instrument is quoted in an active market if quoted prices reflecting normal market transactions are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. “Readily available” means that the pricing information is currently accessible and “regularly available” means that transactions occur with sufficient frequency to provide pricing information on an ongoing basis. “Regularly occurring’ is a matter of judgment and depends on the facts and circumstances of each particular instrument. For example, instruments acquired on the original issuance date or shortly thereafter for which there was no further occurring market transaction are not generally considered to be quoted in an active market.

An absence of transactions for a short period, or a lower than normal volume of transactions, does not necessarily mean that a market has ceased to be active or that observed transactions are distress sales, nor does it necessarily mean that transactions are motivated other than by normal business considerations. If transactions are occurring frequently enough for an entity to obtain reliable pricing information on an ongoing basis, the market is considered active.

Further guidance on identifying an active market can be found in the IASB Expert Advisory Panel education document, *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*. This report notes that there is no bright line between active markets and inactive markets. Refer to the following link for a copy of the IASB Expert Advisory Panel report: http://www.iasb.org/NR/rdonlyres/0E37D59C-1C74-4D61-A984-8FAC61915010/0/IASB_Expert_Advisory_Panel_October_2008.pdf.

5. Would a debt security that is quoted in a market always fail the loans and receivables classification?

No. As discussed above, the test is not whether the investment is quoted in a market, rather whether the investment is quoted in an **active** market.

6. Would an instrument that is legally a debt security always qualify as a loan if it is not quoted in an active market and is not held for trading purposes?

Not always. It is necessary to consider whether other features of the security would preclude classifying the asset as a loan. For instance, a debt security will not qualify as a loan if the holder may not recover substantially all of its investment other than because of credit deterioration. This particular criterion is important in assessing certain types of investments such as debt securities created in a securitization or asset-backed lending.

7. Can an investment that is legally an equity security ever qualify as a loan?

Instruments that meet the definition of an equity instrument under Section 3855 cannot be classified as loans and receivables by the holder. On the other hand, a non-derivative instrument (for example, a term preferred share) that has the legal form of an equity instrument but is recorded as a liability by the issuer and has fixed or determinable payments, can be classified within loans and receivables by the holder provided it is not quoted in an active market and the definition is otherwise met.

8. If an investment in a debt security meets the definition of loans and receivables, can an entity elect another measurement category on initial recognition?

On initial recognition of a financial asset that would otherwise be classified as loans and receivables, an entity may voluntarily designate it as HFT or AFS. However, this asset may not be classified as a HTM investment.

9. An investment in a debt security or a Loan and Receivable must be classified as held-for-trading if it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term. Does Section 3855 define the term "near term"?

No. An entity should adopt an accounting policy defining the near term and apply it consistently.

10. Would an entity that routinely sells some of the loans in its loan portfolio be required to classify its loans as held-for-trading on initial recognition?

A loan would be required to be included in the held-for-trading category only if the loan is acquired or incurred principally for the purpose of selling in the near term or as part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking. Accordingly, the fact that an entity routinely sells some of the loans in its portfolio is not a factor which, by itself, justifies classifying the loan as held-for-trading. What is important is the entity's intention with respect to the particular loan at the date of its origination or acquisition. For example, if an entity acquires or originates a loan intending to sell it in the near term, whether individually or as part of a package, this loan should be classified as held-for-trading.

THE AMENDED REQUIREMENTS FOR RECLASSIFYING FINANCIAL INSTRUMENTS

11. Section 3855 includes provisions permitting the reclassification of an instrument from one measurement category to another. Have these provisions changed and if so, how?

Yes. Certain criteria for reclassification out of the held-for-trading category were amended. After initial recognition, a financial asset may not be reclassified into the held-for-trading from another category. Financial assets that have been voluntary designated as HFT by an entity are not allowed to be reclassified out of held-for-trading. As for the trading financial assets that were required to be classified as HFT, the old Section 3855 allowed reclassifications out of this category only in rare circumstances. Post-amendment, this requirement has been relaxed: a non-derivative financial asset can be reclassified out of the HFT and into the loans and receivables if the financial asset meets the definition of loans and receivables at the date of reclassification and the entity at that date has the intent and ability to hold it for the foreseeable future or to maturity.

12. If an active market emerges for an investment in a debt security that has been classified as loans and receivables under the amended requirements, should the investment be reclassified to the AFS or HTM classification?

Views vary on this question. If an asset that was classified as a loan and receivable becomes quoted in an active market, some believe that continued classification of the investment as a loan and receivable is not appropriate because the asset no longer meets the definition of loans and receivables. Others believe that the criteria for classification into this category have to be met only at the original classification date. In our view, entities should establish an accounting policy of whether to reclassify in these circumstances or not. The chosen policy should be applied consistently. So if an entity chooses reclassification as its accounting policy, it will need to reclassify all loans and receivables that become quoted in an active market as AFS or HTM.

13. After the initial adoption of the amendments, can an investment in a debt security that was classified as HFT or AFS because it was quoted in an active market on initial adoption be reclassified to loans and receivables if it is no longer quoted in an active market?

It depends. In order to qualify for classification as a loan or receivable, the investment must meet the general definition of a loan or receivable at the date of reclassification and also meet the conditions for reclassification under CICA 3855.80A (rare circumstances) or CICA 80BA (the entity has the intention and ability to hold the asset for the foreseeable future or until maturity). “Rare circumstances” are defined as arising from a single event that is unusual and highly unlikely to recur in the near-term.

14. In accordance with Section 3855.87H(a), the carrying value of investments in debt securities reclassified as HTM or loans and receivables is adjusted to reflect any impairment measured in accordance with Section 3025, *Impaired Loans* (“Section 3025”). Does this adjustment include a general allowance for loan losses, if warranted?

Yes. In addition to evaluating impairment in relation to individual loans and receivables, Section 3025 requires that an entity collectively evaluates groups of loans that share identifiable common characteristics. Recognition of impairment for such groups of loans is required when specific events or changes in economic conditions indicate that there has been a deterioration in credit quality for the group as a whole and any resulting impairment may not be reflected adequately by the identification of individual impaired loans. In these circumstances, after allowing for impairment identified on an individual loan basis, an additional allowance for loan impairment is recognized against the remainder of the group.

IMPAIRMENT OF DEBT SECURITIES

15. What are the changes in the impairment rules for debt securities?

Pre-amendment, investments in AFS and HTM debt securities were assessed for impairment under the full fair value model in Section 3855. Under this approach, a decline in fair value of an investment below its amortized cost basis was required to be recognized in income once a fair value decrease is determined to represent an other-than-temporary impairment. Reversals of impairment losses through income were prohibited.

Post-amendment, the requirements for measurement, recognition and subsequent reversals of impairment losses have changed, as follows:

- Investments in debt securities classified as loans and receivables or HTM assets should be assessed for impairment using the incurred credit loss model in Section 3025, *Impaired Loans*. Under this model, impairment losses are recognized in income only when there is no longer reasonable assurance of timely collection of amounts due. The amount of impairment loss usually is the difference between the amortized cost and the present value of expected future cash flows, discounted at the original effective interest rate. If the estimated realizable amount of an investment increases, the amount of impairment is reduced. In some cases, impairment losses can be recognized based on the fair value of the investment.

- Impairment losses on investments in debt securities classified as AFS continue to be measured as the difference between the instrument's cost basis and fair value under the Section 3855 model. However, such impairments are now required to be reversed, with the amount of the reversal recognized in net income, if in a subsequent period the fair value of a AFS debt instrument increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in net income.

Impairment losses under the incurred credit loss model in Section 3025 are often lower than those under the full fair value model in Section 3855.

16. Have the impairment rules for investments in AFS equity securities been changed?

No. The existing guidance on impairment of equity instruments in Section 3855 remains unchanged. Reversal of impairment losses on investments in AFS equity securities is prohibited.

17. Amended Section 3855 states that if, in a subsequent period, the fair value of a debt instrument classified as AFS increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in net income, the impairment loss is reversed, with the amount of the reversal recognized in net income. Can the event that causes the reversal be different than the one which caused an impairment?

Yes, as long as that trigger event can be objectively related to the debt instrument.

18. Would a reversal of an impairment loss be appropriate if a subsequent increase in the fair value of a fixed rate AFS debt security is caused purely by a decrease in market interest rates?

Usually no. A decline in the fair value of a debt instrument that results from an increase in the basic, risk-free interest rate would not normally represent objective evidence of impairment. Consequently, any positive change in such a rate should not be considered to be a reversal of impairment. Generally, unless an event improves the credit standing of the issuer, it is difficult to objectively determine that a subsequent increase in fair value is attributable to such an event.

TRANSITION

19. What is the effective date of the amendments?

The amendments apply to annual financial statements relating to fiscal years ending on or after November 1, 2008. Earlier adoption is permitted for interim financial statements issued on or after August 20, 2009.

20. How does an entity apply the amendments?

By restating affected balances as of the beginning of the fiscal year in which the entity adopts the amendments as if the amended rules had always been in effect. Comparative financial statements, however, are not restated. Instead, retained earnings and accumulated other comprehensive income at the beginning of the year are restated.

21. What reclassifications of investments in debt securities are permitted or required on adoption of the amendments?

As of the beginning of the fiscal year in which the amendments are adopted, an entity:

- MUST reclassify **to HFT** any loans and receivables that, as of the beginning of the fiscal year in which the amendments are adopted, the entity intended to sell immediately or in the near term.

- MAY reclassify **from the HFT** category to HTM or loans and receivables categories, as applicable, an eligible financial asset previously required to be classified as HFT. Reclassification of financial assets that have been previously voluntarily designated as HTF is not permitted.

- MAY reclassify a financial asset **from the AFS** category to the HTM or loans and receivables categories, as applicable.

- MUST reclassify **from the HTM** category to the loans and receivables any investment in a debt instrument with fixed or determinable payments that is not quoted in an active market.

For all reclassification to loans and receivables, an entity assesses whether a debt security meets the definition of loans and receivables as of the beginning of the fiscal year in which the amendments are adopted.

22. Can investments in debt securities voluntarily designated as HFT at initial recognition or on initial adoption of Section 3855 be reclassified at the time of adoption of these amendments?

No. Similar to the recurring reclassification provisions, Section 3855 prohibits entities from reclassifying financial instruments out of the HFT category on initial adoption of the amendments if the entity voluntarily designated the investments as HFT on initial recognition or initial adoption of Section 3855.

23. When an investment in a debt security is reclassified into HTM or loans and receivables on initial adoption of the amendments, what effective interest rate should be used for subsequent measurement at amortized cost?

The original effective rate of the instrument is calculated as if the amortized cost basis was used from the initial recognition date. Any difference between the fair value and amortized cost less impairments as of the beginning of the adoption year is charged to the opening retained earnings.

24. On initial adoption of the amendments, an entity reclassifies an AFS debt security denominated in a foreign currency to loans and receivables. Does management calculate the amortized cost of the financial asset at the date of reclassification in the foreign currency and apply the then prevailing spot rate to translate that amortized cost into to its functional currency?

Yes. The measurement of the financial asset is first determined in the foreign currency and is then translated into the functional currency of the entity holding the investment using the spot rate on the date of the reclassification. Opening retained earnings are adjusted for the amount that would have been charged to earnings in accordance with Section 1651, *Foreign Currency Translation*, had the debt security always been classified as HTM or loan and receivable. Other differences between the new carrying amount and the fair value as of the beginning of the fiscal year are allocated to the opening AOCI balance.

25. How does the new Canadian GAAP model for impairment of investments in debt securities now compare to those under the US GAAP and IFRS?

It is not fully equivalent with US GAAP or IFRS. Refer to the summary table in Appendix A.

APPENDIX A: IMPAIRMENT OF DEBT SECURITIES – SIMILARITIES AND DIFFERENCES

	US GAAP (post-FSP FAS 115-2 and FAS 124-2)	**IFRS**	**Cdn GAAP (as amended)**
When to assess for impairment	There is a decline in the fair value of the investment below its amortized cost at the balance sheet date	Objective evidence of impairment exists at the balance sheet date	Objective evidence of impairment exists at the balance sheet date
Recognition criteria	Decline in fair value is other than temporary ("OTTI"). This occurs if: (a) the entity intends to sell the investment at the balance sheet date (b) it is more likely than not that the entity will be required to sell the security before the recovery of its amortized cost basis (c) The present value of cash flows expected to be collected, discounted at an appropriate rate (which can be the original effective interest rate) is less than the amortized cost basis ("the incurred credit loss")	Objective evidence of impairment	Investment classified as AFS: A decline in fair value has occurred that is other than temporary (no change from the old rules) Investments classified as HTM and loans: There has been a deterioration in credit quality to the extent that the lender no longer has reasonable assurance of timely collection of the full amount of principal and interest.
Measurement of impairment loss	OTTI under (a) and (b) above – full difference between fair value and amortized cost basis is charged to income OTTI under (c) above – the incurred credit loss is charged to income and any difference between amortized cost and fair value is allocated to other comprehensive income	Investments classified as AFS: Difference between FV and amortized cost Investments classified as HTM: Incurred credit loss	Investments classified as AFS: Difference between FV and amortized cost Investments classified as HTM and loans: Incurred credit loss
Reversal of write downs charged to income	Not allowed	Allowed, if certain criteria are met	Allowed, if certain criteria are met