

CICA 3862 and CICA 1535 disclosures: key requirements explained

Outlined below are some of the more significant disclosure changes as compared to the existing rules that companies will need to prepare for. This is not an exhaustive list of the comprehensive disclosures required by FINANCIAL INSTRUMENTS – DISCLOSURES, Section 3862 and CAPITAL DISCLOSURES, Section 1535.

Disclosure of the criteria used to classify financial instruments

Entities will need to disclose the measurement basis or bases used, and the criteria used to determine classification for different types of instruments.

CICA 3862 requires specific disclosures to be made, including the criteria for:

- Designating financial assets and liabilities as trading;
- Designating financial assets as available-for-sale; and
- Determining when impairment is recorded against the related financial asset or when an allowance account is used.

Determining classes of financial instruments

CICA 3862 requires certain disclosures to be given by class of financial instruments, for example, the reconciliation of an allowance account (CICA 3862.16). CICA 3862 does not provide a prescriptive list of classes of financial instruments. CICA 3862 states that a class shall contain financial instruments of the same nature and characteristics and that the classes shall be reconciled to the line items presented in the balance sheet (CICA 3862.6).

A “class” of financial instruments is not the same as a “category” of financial instruments. Categories are defined in CICA 3855 as financial assets held for trading, held-to-maturity investments, loans and receivables, available-for-sale financial assets, financial liabilities held for trading and other financial liabilities.

We would expect classes to be determined at a lower lever than the measurement categories in CICA 3855 and reconciled back to the balance sheet as required by CICA 3862.6. However, the level of detail for a class shall be determined on an entity-specific basis.

In the case of banks, we would expect the category “loans and advances” to comprise more than one class unless the loans have similar characteristics. For example, it may be appropriate to provide separate classes by:

- Types of customers – for example, commercial loans and loans to individuals; or
- Types of loans – for example, mortgages, credit cards, unsecured loans and overdrafts.

However, in some cases, “loans to clients” can be one class if all the loans have similar characteristics (e.g. a credit union providing only one type of loan to individuals).

In the case of investment entities, we would expect, for example, the category “investments in debt instruments” to comprise more than one class unless all the debt instruments have similar characteristics. For example, it may be appropriate to disclose separate classes by:

- Type of debt instruments – for example, government bonds, corporate bonds, asset backed securities, etc.; or
- Credit rating of issuers; or
- Fixed verse floating rate debt, etc.

However, in some cases, “investments in debt instruments” can be one class if all the debt instruments have similar characteristics (e.g. corporate bonds with similar credit ratings).

Disclosure of the components of the fair value movement for certain items designated as held for trading

Where loans and receivables are designated as held for trading, CICA 3862 requires disclosure of the breakdown of the changes in the fair value of these items. This would include, for example, showing the split between changes due to benchmark market rate movements and credit. For example, where a company invests in an interest bearing corporate bond, the change in the fair value of that bond will be due, in part, to movements in benchmark interest rates and any changes in the credit worthiness of the issuing entity.

Disaggregating the fair value movements into these two components is likely to be a significant systems challenge for many. At the same time, it will provide investors and users of the financial statements with an unprecedented level of information about the credit quality and trends of the entity's investments.

Where companies elect to designate their own liabilities (such as bonds they have issued) as trading they will be required to inform investors about the impact that movements in their own credit quality have had on the value of those bonds.

Discussion of the capital management strategy

CICA 1535 relates to capital management disclosures that companies may opt to combine with their risk management information for CICA 3862 disclosure purposes. The main requirements are to disclose quantitative and qualitative information about the entity's objectives, policies and processes for managing capital. When subject to external regulatory requirements, a statement of compliance is also required. This introduces a significantly enhanced level of disclosure about a company's capital management strategy, as well as the implications of its regulatory requirements.

Best practice will be to present a clear and well defined picture of how the strategy enhances shareholder value, while meeting regulators' expectations.

Qualitative disclosures about risks faced and the strategies used to manage them

For each type of risk (credit risk, liquidity risk and market risk) a qualitative narrative is required. This should:

- Identify the risk exposures of financial instruments and how they arise;
- Identify the objectives, policies and processes for managing the risks and methods used to measure risk; and
- Describe any changes from the previous reporting period.

In conjunction with the required quantitative disclosures (see below), this is perhaps one of the most significant disclosures introduced by CICA 3862. Essentially, CICA 3862 requires the company to tell the world what risks weigh on the minds of management and what it is doing about them. It follows that those who have a good story to tell, and tell it clearly, will potentially be rewarded in the marketplace.

Quantitative disclosures about the potential impacts of market risks

For each type of risk, entities must disclose summary quantitative data on risk exposure at reporting date, based on information provided internally to key management personnel and any concentrations of risk.

Entities must also ensure they disclose the following information related to credit risk, liquidity risk and market risk:

Credit risk

- An entity's maximum exposure to credit risk and any related collateral held.
- Information on credit quality of assets that are neither past due or impaired.
- Analysis of the age of financial assets that are past due but not impaired.
- Analysis of financial assets that are individually determined to be impaired.

Liquidity risk

- A maturity analysis for financial liabilities showing the remaining contractual maturities and a description of the approach to managing the inherent liquidity risk.

Market risk

- A sensitivity analysis for each type of market risk (currency, interest rate and other price risk) to which an entity is exposed at reporting date. This should illustrate how profit or loss and equity would have been affected by "reasonably possible" changes in the relevant risk variable, as well as the methods and assumptions used in preparing such an analysis.
- Any changes in methods and assumptions from the previous period and reasons for such a change.

Sensitivity analysis for each type of market risk

- Performing a financial statement impact analysis for each component of market risk to which an entity is exposed proves to be one of the key challenges of CICA 3862. The next page shows a sensitivity analysis which illustrates the potential net income and OCI impact for “reasonably possible” market movements. These movements could be caused by financial instruments classified as held for trading, available-for-sale or held to maturity. Although there is no prescriptive format outlined in CICA 3862 for the presentation of this information, the following case study highlights one way an entity might set out its sensitivity analysis.

Performing the Section 3862 sensitivity disclosure analysis

Case study

Entity A's financial instruments include cash, accounts receivables, trade payables, listed equity securities and borrowings. Listed equity securities include both portfolios classified as fair value through profit and loss ("FVTPL") and available-for-sale ("AFS").

Entity A also enters into derivative instruments (interest rate swaps and foreign exchange contracts) as part of its financial risk management activities. Its borrowings are denominated in CAD and USD, and a proportion of the borrowings are at floating interest rates. Based on historic movements and volatilities in these market variables, and management's knowledge and experience of the financial markets, Entity A believes the following movements are 'reasonably possible' over a 12 month period:

- Proportional foreign exchange rate movement of -10% (depreciation of CAD) and +10% (appreciation of CAD) against the USD, from an example year-end rate of 0.9

- A parallel shift of +1 %/-1 % in market interest rates (CAD and USD) from year-end rates of 7%
- Proportional other price risk movement of equity securities listed on the TSX and NYSE index of +10%/-10%

If these movements were to occur, the impact on consolidated profit and loss and equity for each category of financial instrument held at balance date is presented below. The movements shown are illustrative only; management would need to consider what movements would be considered "reasonably possible" based on historic movements, future expectations and economic forecasts. It would be expected that the assumptions used for this purpose are consistent with the assumptions used internally by management for budgeting and planning purposes and the development of a financial risk management strategy.

	Carrying amount (\$'000)	Interest Rate Risk				Foreign Exchange Rate Risk				Other Price Risk			
		-1%		+1%		-10%		+10%		-10%		+10%	
		Income (\$'000)	Equity (\$'000)	Income (\$'000)	Equity (\$'000)	Income (\$'000)	Equity (\$'000)	Income (\$'000)	Equity (\$'000)	Income (\$'000)	Equity (\$'000)	Income (\$'000)	Equity (\$'000)
Financial assets													
Cash and cash equivalents ¹	4,135	(41)	(41)	41	41	-	-	-	-	-	-	-	-
Accounts receivable ²	610	-	-	-	-	17	17	(14)	(14)	-	-	-	-
Other assets HFT ³	1,300	-	-	-	-	32	32	(26)	(26)	(130)	(130)	130	130
AFS investments ⁴	1,800	-	-	-	-	-	-	-	-	-	(180)	-	180
Derivatives - HFT (foreign exchange contracts) ⁵	88	-	-	-	-	193	193	(158)	(158)	-	-	-	-
Derivatives - designated as cashflow hedges (interest rate swaps) ⁶	8	(71)	(321)	71	321	-	-	-	-	-	-	-	-
Financial liabilities													
Derivatives - designated as cashflow hedges (foreign exchange contracts) ⁷	(310)	-	-	-	-	-	483	-	(395)	-	-	-	-
Trade payables ⁸	(650)	-	-	-	-	(28)	(28)	23	23	-	-	-	-
Borrowings ⁹	(11,935)	59	59	(59)	(59)	(196)	(196)	161	161	-	-	-	-
TOTAL INCREASE/(DECREASE)		(53)	(303)	53	303	18	501	(14)	(409)	(130)	(310)	130	310

- Cash and cash equivalents include deposits at call which are at floating interest rates. Sensitivity to a +1% movement in rates: $[\$4,135 \times 8\%] - [\$4,135 \times 7\%] = \$41k$. Similarly for a -1% movement in interest rates, impact = $-(\$41k)$.
- Accounts receivables include \$150,000 of USD denominated receivables. (USD amount of foreign-denominated debtors at year-end = $[\$150k \times 0.9] = \text{USD } 135k$). Sensitivity to a -10% movement in foreign exchange rates: $[\text{USD } 135k/0.81] - 150k = \$17k$. Similarly for a +10% movement in foreign exchange rates, $[\text{USD } 135k/0.99] - 150k = \$(14k)$.
- Other HFT assets are listed equities on the TSX and NYSE, and include \$290,000 of USD denominated shares (USD value = $290,000 \times 0.9 = \text{USD } 261k$). Sensitivity to a -10% movement in FX rates: $[\text{USD } 261k/0.81] - \$290k = \$32k$. Similarly for a +10% movement in FX rates, $[\text{USD } 261k/0.99] - \$290k = \$(26k)$. Sensitivity to a +/-10% movement in Canadian and US share prices: $\pm/[-\$1,300k \times 10\%] = \pm\$130k/(\$130k)$.
- AFS investments are all listed on the TSX and denominated in CAD. Sensitivity to a +/-10% movement in the Canadian listed equity price index: $\pm/[-10\% \times \$1,800k] = \$180k/(\$180k)$. Movement impacts other comprehensive income.
- Derivatives that are HFT are foreign exchange contracts. A +/-10% shift in foreign exchange rates has an impact of $\$193k/(\$158k)$, based on a derivative valuation model with theoretical forward rates.
- Derivatives designated as cash flow hedges are interest rate swaps used to hedge floating rate future interest expense. Based on outputs from a derivative valuation model, which utilizes spot and forward interest rates and discounted cash flow analysis, a parallel shift of +/- 1% in base interest-rates results in an impact on derivative valuation of $\$250k/(\$250k)$, and on realized receipts/(payments) on the interest rate swap during the period of $\$58k/(\$58k)$. As Entity A achieves hedge accounting, the realized receipts/(payments) on the interest rate swap approximates the amounts that would be released from hedging reserve in other comprehensive income to net income during the period to match the interest expense on underlying borrowings. As a result, an impact to net income of $\$58k/(\$58k)$ results from the +/- 1% movement in base interest rates. In addition, the derivative is 5% ineffective, giving rise to a net income sensitivity of $\$13k/(\$13k)$.
- Derivatives designated as cash flow hedges are foreign exchange contracts used to hedge against the CAD:USD foreign exchange risk arising from foreign denominated future purchases. Based on outputs from a derivative valuation model, a +/-10% shift in the CAD:USD foreign exchange rate has an impact of $\$483k/(\$395k)$ on derivative valuation. There is no net income sensitivity as the hedges are 100% effective.
- Trade payables includes \$250,000 of USD denominated trade payables. (USD balance of foreign denominated payables at year-end = $\$250k \times 0.9 = \text{USD } 225k$). Sensitivity to a -10% movement in the CAD:USD foreign exchange rate: $[\text{USD } 225k/0.81] - \$250k = \$(28k)$. Similarly for a +10% movement in foreign exchange rates, $[(\text{USD } 225k)/0.88] - \$250k = \$23k$.
- Borrowings include $\$5.88m$ of floating rate borrowings at a weighted average rate of 8.5%, and $\$1.77m$ of USD denominated debt (USD balance = $[\$1.77m \times 0.9] = \text{USD } 1.593m$). Sensitivity to a -1% movement in interest rates: $[\$(5.88m) \times 7.5\%] - [\$5.88m \times 8.5\%] = \$59k$. Similarly for a +1% movement in interest rates, $[(\$5.88m) \times 9.5\%] - [\$5.88m \times 8.5\%] = \$(59k)$. Sensitivity to a -10% movement in the CAD:USD foreign exchange rate: $[\text{USD } 1.593m/0.81] - \$1.77m = \$(196k)$. Similarly, a +10% movement in the CAD:USD foreign exchange rate, $[\text{USD } 1.593m/0.99] - \$1.77m = \$(161k)$.

Note: As Entity A has hedged its floating rate debt exposure with interest rates swaps, this profit impact of $59k/(\$59k)$ is largely offset by movements on interest rate swaps designated as cash flow hedges of $(58k)/58k$ as per footnote 6.