CL 17

Memo

To: International Accounting Standards Board

From: Canadian Accounting Standards Board Staff

Date: October 11, 2002

Re: **Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement, June 2002**

The following comprises the response of Canadian Accounting Standards Board staff (AcSB staff) to the IASB's exposure draft of proposed amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement, dated June 2002.

Although the Canadian accounting standard on presentation and disclosure of financial instruments is essentially identical to IAS 32 as a result of the joint IASC / AcSB project, currently there is no Canadian standard dealing with the recognition and measurement of financial instruments.

The AcSB has added a project to its technical agenda to deal with the recognition and measurement of financial instruments[1] and agreed, in the interests of convergence, that the resulting pronouncements should be consistent with IASB and FASB financial reporting standards. The Canadian exposure draft, expected to be issued in the first half of 2003, will be

[1] This will also reconsider disclosure, but not presentation or offsetting.

based on IFRS, but will seek to ensure that there are no instances where complying with the resultant Canadian pronouncements would preclude an entity from also complying with US GAAP. Accordingly, we urge you to ensure that any differences between the revisions to IAS 39 and current US standards be kept to a minimum and any differences justified. In this regard, we have also advised FASB staff of potential areas where modification to US standards would facilitate convergence with IAS 39.

While we agree that the improvements to IAS 32 and IAS 39 are a necessary step forward, we do not believe that the revised IAS 39 is an acceptable final answer to the issue of accounting for financial instruments and question whether a mixed attribute model provides the best measurement of the economic events that IAS 39 is attempting to capture. We strongly urge the IASB to provide the leadership to adopt a better solution.

Our detailed comments on the questions in the Invitations to Comment and other matters are set out in the following pages. We would be pleased to elaborate on these points in more detail if you so require. If so, please contact Ron Salole, Director Accounting Standards at +1 416 204-3277 (e-mail ron.salole@cica.ca), or Ian Hague, Principal Accounting Standards at +1 416 204-3270 (e-mail ian.hague@cica.ca).

IAS 32: Financial Instruments: Disclosure and Presentation

Responses to Questions

Question 1 - Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)

Yes, we agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement. We believe that this is consistent with the Framework definition of a liability.

Question 2 – Separation of liability and equity elements (paragraphs 28 and 29)

Yes, we agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element. Not only does this eliminate a choice within IAS 32, but also the alternative chosen is consistent with the Framework definition of equity as a residual and we believe is less likely to be arbitrary, and would be simpler to apply, than the relative-fair-value method.

Question 3 – Classification of derivatives that relate to an entity's own shares (paragraphs 29C – 29G)

Yes, we agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares. In particular, we concur with the principle that only those derivative contracts that result in an exchange of a fixed amount of cash or other financial assets for a fixed number of an entity's own equity instruments (other than derivatives) should be accounted for directly in equity. Derivative contracts that are indexed to the price of an entity's own equity interest do not evidence a residual interest in the entity unless they are required to be settled in the entity's own shares.

Question 4 – Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard

We believe that it is important to make the text of the standards on financial instruments as user-friendly as possible. In this regard, we support the approach of including certain more detailed implementation guidance and illustrative examples in Appendices. It may be useful to include all of the standards related to financial instruments as a single package, but it seems unnecessary to integrate the entire text in IAS 32 and IAS 39 into one comprehensive Standard. In Canada, we propose to include the requirements for hedge relationships and hedge accounting in documents separate from the main recognition, measurement and disclosure standard on the grounds that, for users who do not adopt hedge accounting, referring to this material is unnecessary. We also plan to move the disclosure requirements from our presentation and disclosure standard (Section 3860) to the recognition and measurement standard, leaving Section 3860 to address liability and equity presentation and offsetting only[2]. Derecognition of financial assets is also a sufficiently complex topic in its own right that it probably warrants a separate document.

Other comments

Scope

Paragraph 1(e): We agree that most contracts that require a payment based on climatic, geological or other physical variables should be excluded from the scope of the Standard. However, we believe that when such contracts are either traded on an exchange or held for trading they should fall within the scope of the Standard. In these cases, the contracts are no different from other financial instruments. This would also be consistent with US GAAP for such contracts (see for example FASB Statement 133 and EITF 99-2). See also our similar comment on IAS 39.

[2] We plan to amend this standard as part of a broader project on liabilities and equity.

Disclosure

Paragraph 43(d): The amendment to the description of "cash flow risk" to describe only "cash flow interest rate risk" seems to restrict the risks that would be taken into consideration in making disclosure so as to exclude other cash flow risks – such as the risk that future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. We suggest that the broader notion of cash flow risk also be described.

Paragraph 49: We suggest that the terms and conditions of financial instruments should also require disclosure of any features of a financial instrument that significantly concentrate or leverage risk (for example, a significant leverage factor in a derivative financial instrument, such as a requirement for payments based on a significant multiple of changes in fair value of an underlying price or index, that, if triggered, could be material to the enterprise's financial performance). Regulators have called for this disclosure previously, and we believe that this would provide useful information about the relative risk associated with certain instruments or residual interests.

Paragraph 93A: We suggest that an entity should also disclose the nature and extent of any restrictions on its ability to dispose of or use financial assets, through legal or contractual requirements that arise outside the financial instrument contract, such as requirements to maintain liquid financial assets, or stipulations on the use of certain financial assets. Such information is valuable to understand the extent to which an entity's use of financial instruments is limited.

Editorial

Paragraph 4A: In the penultimate line the words "receipt or" should be included for consistency with the proposed changes to IAS 39, paragraph 6.

Paragraph 5: In each of the definitions of "financial instrument," "financial asset" and "financial liability" we believe that it would be more appropriate to refer to "one party" or "another party", rather than "entity," to ensure that instruments where the other party is not an "entity" are not excluded. Paragraph 7 would then become unnecessary.

Paragraph 22A: The parenthetical comment at the end of this paragraph is not clear.

Paragraph 46: We suggest that the phrase "such as obligations under retirement benefit plans or insurance contracts" in the last sentence of this paragraph be deleted. This paraphrases only parts of paragraphs 1(b) and (c) and could be misleading. The phrase seems unnecessary here.

Paragraph 93A: This paragraph contains a mixture of "other disclosures". It would be more user-friendly if these could be grouped in a logical order – such as those relating to derecognition, those relating to income statement presentation, etc.

IAS 39: Financial Instruments: Recognition and Measurement

Responses to Questions

Question 1 – Scope: loan commitments (paragraph 1(i))

Yes, for practical reasons, we agree that a loan commitment that cannot be settled net and that the entity does not designate as held for trading should be excluded from the scope of IAS 39.

Question 2 – Derecognition: continuing involvement approach (paragraphs 35-57)

No, we do not agree with the proposed continuing involvement approach as the principle for derecognition of financial assets under IAS 39. We concur fully with the dissenting views on this subject expressed in paragraphs D1 to D5 of Appendix D to the exposure draft. We agree that the present requirements of IAS 39 are not of sufficient high quality. However, we do not believe that it is appropriate to replace these requirements with a new model that is not only different from those already existing in other national standards, but also is untested and contains contradictions with the Framework. We would prefer the IASB to adopt an interim approach that converges with principles in existing national standards and to then expedite work with national standard setters to develop a robust model for derecognition. We note that we do not intend to include this aspect of the IASB proposals in the proposed Canadian standard on recognition and measurement. Rather, we will retain our Accounting Guideline that adopts the major aspects of FASB Statement 140.

Question 3 – Derecognition: pass-through arrangements (paragraph 41)

Yes, we agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft, subject to the interaction with the continuing involvement approach, with which we disagree (see answer to Question 2, above).

Question 4 – Measurement: fair value designation (paragraph 10)

Yes, we agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognized in profit or loss. We believe that this appropriately simplifies the Standard and also allows entities that wish to avoid some of the anomalies of the different measurement bases in IAS 39 to do so. We concur that this designation should be irrevocable at initial recognition.

Question 5 – Fair value measurement considerations (paragraphs 95-100D)

Yes, we agree with the requirements about how to determine fair values that have been included in paragraphs 95–100D of the Exposure Draft and paragraphs A15–A25 of Appendix A. We believe that the requirements provide an appropriate balance between those that are necessary and sufficient to consistently apply the Standard.

Question 6 – Collective evaluation of impairment (paragraphs 112 and 113A–113D)

Yes, we agree that a loan asset or other financial asset measured at amortized cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment, in order to reflect the fact that impairment might be probable in a group of assets, when it is not probable in assessing an individual asset in that group. Yes, we agree with the methodology for measuring such impairment in paragraphs 113A-113D.

Question 7 – Impairment of investments in available-for-sale financial assets (paragraphs 117–119)

Yes, we agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed. We believe that this is consistent with the rationale that requires recognition of gains and losses on available-for-sale financial instruments directly in equity in the first place.

Question 8 – Hedges of firm commitments (paragraphs 137 and 140)

Yes, we agree that a hedge of an unrecognized firm commitment is a fair value exposure that should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present. This brings greater convergence, in particular with US GAAP.

Question 9 – 'Basis adjustments' (paragraph 160)

Yes, we agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognized directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability. Not only does this result in greater convergence with US GAAP, but also avoids adjusting balance sheet carrying amounts, merely because of the effects of designated hedging relationships.

Question 10 – Prior derecognition transactions (paragraph 171B)

No, we believe that prior derecognition transactions should be grandfathered and disclosure should be required of a general description of the assets and liabilities that have been derecognized that would not have been derecognized had the Standard been in effect. Although ideally a financial asset that was derecognized under the previous derecognition requirements in IAS 39 should be recognized as a financial asset on transition to the revised Standard if the asset would not have been derecognized under the revised derecognition requirements (i.e., prior derecognition transactions should not be grandfathered), we believe that this is likely to be unduly onerous. We also believe that it would be unduly onerous to identify the balances that would have been recognized had the new requirements been applied. In the interests of establishing a common approach to derecognition in the future, we recommend that a more practical approach be adopted in this situation.

Other comments

Scope

Paragraph 1(h): We agree that most contracts that require a payment based on climatic, geological or other physical variables should be excluded from the scope of the Standard. However, we believe that when such contracts are either traded on an exchange or held for trading they should fall within the scope of the Standard. In these cases the contracts are no different from other financial instruments. This would also be consistent with US GAAP for such contracts (see for example FASB Statement 133 and EITF 99-2). See also our similar comment on IAS 32.

Paragraph 3: We suggest that it would be clearer to explicitly exclude from the scope contracts that require a payment based on specified volumes of sales or service revenues of one of the parties to the contract and which are not traded on an exchange, rather than to state that "This Standard does not change the requirements".

Definitions

Paragraphs 8 and 10: We believe that it would be desirable for convergence between the basic definitions of "financial instrument", "financial asset", financial liability," "hedged item," "hedging instrument," and "derivative" between IASB and US GAAP. The first five definitions are used in essentially similar manners (although not all are defined in FASB standards most are explained in the text). Minor wording differences should be avoided. With regard to the definition of a derivative (and its interaction with net settlement requirements) we have advised the FASB that we prefer the IASB approach and suggest that efforts be made to converge by modifying the FASB definition.

Paragraph 10 – Hedging instrument: We continue to believe that an entity should be allowed to designate non-derivatives as hedging instruments if the criteria for hedging otherwise are met. We believe that there are instances where valid hedges can be designated for risks other than foreign currency. One example is the use of securities to hedge the interest risk exposure in mortgage commitments. We note that the FASB acknowledges that there might be other valid risk offsets. However, the FASB did not wish to extend the applicability of hedge accounting beyond that which it viewed as essential. These situations are more prevalent outside the United States, where the existence of liquid markets for relevant derivative instruments is still not common. Some aspects of this issue are mitigated by the ability to elect fair value measurement for any financial instruments. However, this will not alleviate the situation when a single risk within a financial instrument is the subject of the hedge. We recognize that a change on this subject would probably be viewed as more fundamental than an "improvement". However, we note that we plan to continue to allow designation of certain non-derivatives as hedging items when we implement an equivalent standard to IAS 39 in Canada.

Derecognition of a financial liability

Paragraph 59(b): This paragraph refers to release from "primary" responsibility for a liability. We understand that there is no legal distinction between primary and secondary (or other) obligations – an entity is either obligated or it is not. We understand that the FASB is presently seeking to resolve this issue and suggest that the IASB look to the outcome of those deliberations for guidance as to how to amend this paragraph.

Held-to-maturity investments

Paragraph 82: We disagree with the proposed amendment to this paragraph to preclude a financial asset that is puttable by the holder from being classified as a held-to-maturity investment. Any financial asset with a ready market might be considered just as "puttable" because it can be easily sold in the market as one that contains a specific put option to the issuer. We suggest that the position in US GAAP (and existing IAS 39) be retained, whereby a puttable financial instrument is permitted to be classified as held-to maturity if the holder has the positive intent and ability to hold it until maturity and not to exercise the put feature.

Paragraph 83(b): The modification of the example of what constitutes substantially all of the financial asset's original principal from "for example, 90 per cent" to "at least 85 per cent" seems an unnecessary divergence from US GAAP. While we have no particular preference for either of these positions, we suggest that this be converged with US GAAP.

Editorial

We suggest that it would make the Standard easier to use if relevant Application Guidance and Illustrative Examples were to be directly cross-referenced from the text of the Standard.

Paragraph .089B: We suggest deletion of the opening phrase of this paragraph. This is not a requirement, but the justification for the requirement that follows.

Paragraph 103(a): We suggest that the parenthetical comment be deleted. This is already covered in the definition of "held-for-trading" and seems out of place here.

Paragraph 110(c): We suggest that "issuer" and "holder" replace the words "lender" and "borrower", since this paragraph relates to more than just loans.

Paragraph 137(c): It does not seem appropriate to define a hedge of a net investment in a foreign entity as "defined in IAS 21", since that does not appear as a defined term in IAS 21. We suggest that this be defined in IAS 39 as "a hedge of the foreign currency exposure of a net investment in a foreign entity". Reference might then be made to IAS 21 to understand the term "net investment in a foreign entity".

Summary of responses to questions

The following provides a summary of our responses to the questions in the Invitations to Comment. Please see our detailed response for further details. Also, please note that our detailed response raises other matters related to a number of the proposals that do not directly relate to the questions asked in the Invitations to Comment.

Question #	Agree	Disagree	Other
IAS 32 Q1	√		
IAS 32 Q2	√		
IAS 32 Q3	√		
IAS 32 Q4			See comments.
IAS 39 Q1 IAS 39 Q2	√	 X	
IAS 39 Q3	√		
IAS 39 Q4	√		
IAS 39 Q5	√		
IAS 39 Q6	√		
IAS 39 Q7	√		
IAS 39 Q8 IAS 39 Q9	√ √		
IAS 39 Q10		X	