

Financial Instruments

Summary of AcSB roundtable discussions of March 2003 proposals

Introduction

Several roundtable discussions were held to consider the March 2003 AcSB proposals for *Financial Instruments - Recognition and Measurement*, *Hedges*, and *Comprehensive Income*. In late September and early October 2003 discussions took place in Edmonton, Calgary, Vancouver, Montreal (in French) and Toronto. Discussion also took place with representatives of the not-for-profit sector (NFPs) in June 2003.

These discussions involved 84 participants from a wide range of backgrounds and interests.

Several AcSB members and members of the AcSB staff participated in the discussions.

The following summarizes the major matters raised by participants¹. It does not purport to be a complete record of all matters raised. However, it does provide an overview of the kinds of issues raised and the variety of views expressed.

Overall approach and relation to US GAAP

Many companies are finding that their auditors (and securities regulators) are insisting on using US GAAP/DIGs etc. to fill in the areas intentionally left blank in AcSB material. This is causing some confusion and frustration. Canadian preparers are unclear as to the status of additional US material, such as DIGs. [Montreal & West]

Many businesses in Quebec (especially small businesses) express concern that they are not able to follow developments in the US. They simply can't afford doing it (and US standards are not available in French). [Montreal]

In contrast to views in Montreal and the West, there is a high level of dissatisfaction in Toronto with using IAS 39 as the starting point for Canadian standards. Accounting firms and companies are familiar with US words, whereas IAS 39 was characterized as an "unproved product". There is a desire to use the same words as US GAAP, including a common definition of derivative, to ensure Canada/US differences are not present. There is also a desire for more information to help with application of the words. [Toronto]

Some suggest that, if there are aspects of US GAAP that specifically should not be looked to, because they are inconsistent with Canadian conclusions, these should be identified. [West]

There is significant worry that the material is overly complex and that one result will be an election by some to use compilation, rather than audit, engagements to avoid the GAAP requirements. [West]

¹ Locations in which matters arose are noted in square brackets.

The fair value measurement option

Many did not seem to understand the reason for the free choice to measure any instrument at fair value through net income, but seemed to accept its benefits once it was explained that the option may alleviate the need for hedge designation and documentation in certain situations where both sides of a hedge relationship can be measured at fair value, or reduce the need for bifurcation of embedded derivatives when the entire contract can be measured at fair value – indeed some considered the option essential. Also, there is a widespread concern that this free choice could be abused if there is no explicit requirement that the estimated fair value must be reliably determinable. [West] There is a concern about how these items are presented and labelled since they are not, in fact, held for trading purposes. [Toronto & West]

Insurance companies need the fair value option to get symmetrical results. However, the proposal may be too restrictive; should also give some scope for designating items as held for trading other than at inception. [Toronto]

The fair value option is particularly important where a risk is hedged but doesn't qualify for hedge accounting (e.g., credit derivatives). However, it was noted that the fair value option is not a perfect solution for credit derivatives, because of the requirement to designate on initial recognition. [Toronto]

Some raised concerns about the potential for abuse if an entity is permitted to measure their liabilities at fair value in which case they report gains in income if their credit risk deteriorates. [West]

Several expressed a desire for more flexibility in reclassifying items in and out of held for trading. [Montreal]

Measurement reliability

Many were not familiar with the fair value measurement guidance, but there was a general sense that it should be sufficient, but not overly prescriptive. [Toronto & West]

Some questioned whether auditing standards can keep pace on the audit implications when fair value estimates are used. It was suggested that guidance is needed, as well as the need to develop expertise, before reliable fair values can be developed – and that this will take time. [Toronto]

Significant discomfort was expressed with basing fair value estimates on quoted market prices of thinly traded junior companies. The view was that results might be misleading and might not be indicative of what the marketplace would actually value many holdings at. [West]

Several suggested considering the applicability of the discussion of recognition of inception profit in EITF 02-03. [Montreal & Toronto]

Some noted that disclosure of fair value methodologies would support measurement reliability. [West]

Impairment

It was suggested that the AcSB provide guidance for impairment where a decline in value is other than temporary (Refer to recent EITF guidance in US.). [Montreal & Toronto]

Hedges

Several questions were raised as to what happens when a cash instrument is designated as a hedge:

- What category is it in when designated, because treatment is no longer consistent with held-to-maturity?
- What happens to a cash instrument when an effectiveness test fails? [A derivative that fails an effectiveness test is handled under EIC-128]
- Is the time value of a cash instrument used as a hedging item included or excluded?
- Why is the measurement basis of a cash instrument not adjusted for the entire change in fair value, rather than that which is related to the hedged risk? [to be consistent with derivatives].
- It was noted that FASB saw a lot of conceptual problems and, hence, decided to avoid cash instrument hedging in most cases. [Toronto]

Regarding the IASB proposal to allow macro hedging in certain circumstances, many participants agreed that implementation would be difficult, but some believed that the idea should not be abandoned as it would allow options that financial institutions could use. Macro hedging could avoid transaction costs as well as the need for certain system changes. It was also suggested that macrohedging is more common in Canada than the US because of the greater amount of borrowings in foreign currencies.[Montreal & Toronto]

Even though the IASB macro hedging proposal does not deal adequately with deposit liabilities, their management is a core feature of financial intermediation and accounting should address this issue in the future. [Toronto]

Some expressed concern that hedge accounting does not always match economics – but few specific examples were provided. There was also some concern that hedge accounting is based on instrument by instrument tracking, but entities hedge net positions. [West]

There is a desire to be able to elect hedge accounting for a component of a contract – such as the interest risk in production from an oil well. [West]

Comprehensive income (OCI)

Some discomfort was expressed with the presentation of OCI as an element of retained earnings since it is neither 'retained' nor 'earnings' in the usual sense of the words as used for accounting purposes. [West]

Significant discomfort was expressed with the option of presenting OCI in a single statement with net income. It was suggested that this would confuse people as to the "real" bottom line. (However, no one was aware whether any problems had arisen when FASB adopted this display

several years ago). Participants were generally content to create OCI as long as it was separate and distinct from any measure of net income. Desire to have same range of choices of presentation available as under US GAAP. [West]

OCI was not considered to make sense for Governments. [West]

Some concern was expressed about introducing OCI for a temporary period, pending a broader consideration of the presentation of comprehensive income. [West]

Some expressed a view that, ideally, comprehensive income should disappear and everything should be included in the income statement. [Montreal]

Disclosures

Concern was expressed that there are too many disclosure requirements. Once information is presented on the balance sheet and information is provided in other comprehensive income, disclosures should be minimal. [Montreal]

Concern was also expressed about disclosing strategies. It was suggested that it should be sufficient that, if an entity was wrong and things didn't work out very well, this is reflected in the financial information provided. [Montreal]

Related Party Transactions

There is widespread concern about the interaction with Related Party Transactions, Section 3840. Most participants seem to believe it is not realistic or appropriate to attempt to determine fair values for balances arising from related party transactions. For example, loans often don't have fixed repayment terms; terms can be changed at will; there is no basis for estimating market-equivalent interest rates. However, it was unclear exactly which related party transactions are a concern – for example, a transaction with a financing subsidiary may not justify any special treatment. [West]

Differential reporting / smaller entities

There was general agreement that it would be useful to simplify the material in some fashion for small companies/small audit firms. This might be a flowchart or 'road map' at the outset that allows a reader to discern quickly which sections of the document are likely to be relevant in their particular circumstances. [West]

In the case of small businesses, it was proposed that differential reporting should be allowed with respect to fair value measurement. Fair value should be used for derivatives, but in other cases, differential reporting should be possible, for example for long term investments, shareholder loans, and not for profit organization loans with variable repayment conditions. [Montreal]

Insurance

Defaulting to available-for-sale is problematic for insurance companies, because of the mismatch arising from gains and losses recorded in OCI. Insurers desire accommodation for certain gains and losses on liabilities to be recorded in OCI to match assets. [Montreal & Toronto]

Participants from the insurance industry believe an accommodation for available-for-sale and tainting is appropriate for their industry (they feel the proposals regarding categorization are too restrictive). [Toronto]

It was suggested that market-related smoothing gives time to solidify/true up estimates of fair value. [Toronto]

There was some concern about two changes for insurance companies – one for financial instruments, the second for insurance contracts. [Toronto]

Insurance companies should account for their financial instruments just like banks. There should be no scope exclusion for life-insurance contracts. [Montreal]

Public Sector / Governments

More consideration needs to be given to the application or non-application to public sector entities. Particular concerns include the relevance of fair value measurements and especially the resultant volatility of net income for many public sector entities given their special objectives/functions in society. [West]

Governments sometimes turn to GAAP for the private sector (the *CICA Handbook - Accounting*) when no standard exists in the public sector. It should be clarified that the standards on financial instruments do not apply to public sector entities. [Montreal]

If public enterprises use other comprehensive income, a problem will arise on consolidation, as OCI does not exist in government financial statements. It may be preferable to exclude public enterprises from the scope of the standard. [Montreal]

One participant expressed the view that there should be no difference for public sector entities, since the financial instrument contract they are accounting for is the same as for private sector entities. [Montreal]

Not-for-profit organizations (NFPs)

More consideration needs to be given to the application or non-application to not-for-profits. Particular concerns raised for NFPs include the fact that OCI, when combined with NFP accounting requirements, results in excessive complexity and will confuse users of NFP financial statements, and that the level of disclosures is excessive compared to benefits of the disclosures to users. [West]

Need for implementation support / education

Many expressed a general concern that implementation will require time/resources; need adequate lead time. [Toronto]

Small companies/small audit firms could use more "debits and credits" how-to guidance/examples. There is a significant need for education/training- not necessarily AcSB's mandate but somebody must do it. [West]

Many would like non-mandatory practice aids/implementation guidance. Implementation issues will need to be monitored on an ongoing basis. [Toronto & West]

More examples should be provided, in particular for fair value and cash flow hedges using both derivatives and non-derivatives, for the accounting for an available-for-sale financial asset (3855.67(b)), and for more controversial situations. [Toronto]

Consideration should be given to educating banks and leasing companies as users of financial statements (as well as financial analysts for public companies) so that they understand the new requirements. [West]

Transition

Some want to adopt early because they want the fair value option to get better matching between their foreign currency denominated debt and the instruments they use to hedge it. Motivation for early adoption is, to a large extent, dissatisfaction with AcG-13 being too restrictive. [Toronto]

Short implementation date won't give sufficient time to ensure correct implementation, to answer implementation questions, or for system changes. [Montreal & Toronto]

Entities are still struggling to apply AcG-12, 13 and 15. Implementation date for next stage of proposals should be delayed. [Montreal]

Private companies are not resourced to cope with the proposals. Furthermore, they have only very recently begun to cope with 3860. There should be a delayed effective date for them so that they can learn from the experience of public companies. [West]

Companies must always try to guess what the US will be doing. Sometimes, they have to start all over again when new changes are made, and this entails significant costs. More time is needed to understand complex standards and to change information systems. Standards don't stop evolving, so you're never up to date. [Montreal]

Can the proposal be broken up (staged) – for example, provide the fair value option first [because the most pressing problem is the prospect of AcG-13 becoming mandatory without it] then add the rest later; with the fair value option cash instrument hedging won't be needed? [Toronto]

Other issues

Scope: Commodities

Take-or-pay contracts: these arrangements are very common and it would be useful for AcSB to indicate whether the embedded option can qualify as normal purchase and sale contracts. [West]

"Settlement of differences" contracts, for example, by physical delivery to a power pool: request clarification whether they can qualify as physical delivery contracts. [West]

Scope: Interaction with other Sections

A worry that there will be arbitrary boundary issues resulting in financial instruments carried at fair value when other similar investments are not. One example given was an equity investment in a real estate company/REIT compared to a direct investment in the underlying real estate assets. [West]

Workers' Compensation Boards

WCB representatives are very concerned about the resultant volatility of reported income and the potential destabilizing effect on rate-setting, as well as the consequences for investment policies (fund managers will move to less volatile and, therefore, lower return portfolios ultimately resulting in higher overall premiums). They are worried that the public will confuse accrual earnings with cash earnings. They strongly support retention of a smoothing mechanism, e.g., 5-year averaging, or exemption from the scope of the standards on the grounds that the typical disability payout can span decades. They also argue that WCBs are different in that they are established by government; don't compete with public companies, so comparability with other companies is not important. [Montreal, Toronto & West]

Taxes

A worry that there could be unexpected and inappropriate effects on income and capital taxes if fair value measurements used in the GAAP financial statements are also used for tax purposes, [West]