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September 14, 2009

International Accounting Standards Board  
30 Cannon Street,  
London EC4M 6XH  
United Kingdom

Dear Sirs,

This letter is the response of the Canadian Accounting Standards Board (AcSB) to the IASB's Exposure Draft *Financial Instruments: Classification and Measurement* dated July 2009. Also attached, as an appendix, are detailed AcSB staff responses to the questions posed in the Exposure Draft.

The AcSB agrees that new accounting standards for financial instruments are needed. However, the AcSB is very concerned that the speed with which the proposals are being developed and the apparent lack of co-ordination between the IASB and the US Financial Accounting Standards Board (FASB) will not result in the best possible accounting standards for financial instruments. The IASB has resisted requests for piecemeal changes to financial instrument standards in the past. We think it is imperative that you continue to do so. Responding to demands for urgent action in such a complex area is likely to produce sub-optimal, if not seriously flawed, results.

The AcSB strongly believes that the IASB should develop new financial instrument standards in co-ordination with the FASB. The recent financial markets crisis has focused considerable negative attention on accounting standards for financial instruments. The G20 have stressed the importance of a single set of accounting standards to help prevent a similar crisis in the future. The AcSB thinks that it is critically important that accounting standards for financial instruments be globally converged and implemented concurrently. Any other outcome will simply perpetuate the continuous demands for "level playing fields".

The AcSB also thinks that any reconsideration of the scope of cost or amortized cost measurement for financial assets is incomplete without a revised impairment model. The IASB may believe that its conclusions on impairment and hedging will not affect its decisions on classification and measurement, but we are not convinced. In addition, few constituents will be able to estimate fully the potential effects of the proposed changes without seeing a revised hedge accounting model. The AcSB strongly encourages the IASB not to proceed until a comprehensive proposal on financial instrument accounting is developed and exposed for comment. Otherwise, the IASB should indicate clearly its willingness to fundamentally reconsider the classification and measurement standard in response to issues identified in subsequent phases. We also recommend that a comprehensive proposal be exposed for at least 120 days to allow constituents sufficient time to assess whether the proposals will better meet the information needs of users.

We would be pleased to elaborate on any of our comments in more detail if you require. In this case, please contact Peter Martin, Director, Accounting Standards +1 416 204-3276 (email [peter.martin@cica.ca](mailto:peter.martin@cica.ca)), or Kate Ward, Principal Accounting Standards at +1 416 204-3437 (e-mail [kate.ward@cica.ca](mailto:kate.ward@cica.ca)).

On behalf of the Board



Patricia O'Malley  
Chair, Accounting Standards Board

**APPENDIX**  
**Canadian Accounting Standards Board Staff Detailed Response**  
**to the IASB July 2009 Exposure Draft on**  
**Financial Instruments: Classification and Measurement**

This Appendix is the response of the staff of the Canadian Accounting Standards Board (AcSB) to the detailed questions in the IASB Exposure Draft, *Financial Instruments: Classification and Measurement*. Our response is intended to complement that of the AcSB. Due to time constraints, we were unable to consider all of the questions posed in the Exposure Draft in as much detail as we would have liked.

The AcSB staff held discussions with representatives of several industries, their advisors and users of their financial statements. Industry-specific consultations were undertaken with representatives of the Canadian insurance and banking industries. Although we considered all input received, the views expressed do not necessarily represent a common view of the AcSB, its staff, or other stakeholders with whom we consulted.

In summary, we think that:

- Current financial instrument accounting standards need improvement because:
  - There are too many possible treatments for similar items.
  - The available-for-sale category is operationally challenging and not well supported from a theoretical perspective.
  - Identifying and accounting for contracts with embedded derivatives is complicated.
  - The criteria for recognizing impairment of financial assets is inconsistent both between international and US standards, and between similar financial assets within those sets of standards.
  - Hedge accounting is difficult to apply and both the standard and the results are difficult to interpret.
- These problems are not so urgent as to warrant unilateral changes by either the IASB or the FASB:
  - Financial markets are global; accounting standards for the products that trade in those markets should be globally converged.
- The problems are also not so urgent as to justify compromising due process:
  - Financial instruments are often complicated; standards should be developed only after rigorous assessment of all major issues, consideration of application challenges, and adequate consultation with all constituent groups, not just a few industries and their prudential regulators.
  - Proposals published for public comment need to be comprehensive:
    - Classification and measurement of financial instruments cannot be considered independently of requirements for recognizing and measuring impairment or hedge accounting.
    - The issues raised in the Discussion Paper, *Credit Risk in Liability Measurement*, are also relevant to classification and measurement.

- Given the complexity of the issues, adequate response times are necessary for constituents to consider the proposals properly if they are to be able to provide the IASB with useful feedback.
- It is unlikely that any entities will be able to apply the standard for December 2009 year-ends.
- Classifying instruments into only two categories is a promising approach and we support incorporation of a business model-based approach:
  - We think that the business model is an appropriate criterion but that the notion of contractual yield management needs some refinement.
  - We also think that the basic loans features criterion is on the right track but requires considerable additional work to be operational.

Since Canadian entities will be adopting IFRSs for the first time in 2011, they will need to assess the desirability of adopting the proposals early, either at transition or subsequently. We are concerned that the proposed consequential amendments to IFRS 1 do not mirror the transitional provisions in the proposed standard.

***Question 1 – Decision-usefulness of amortized cost measurement***

In general, we think that amortized cost measurement can convey useful information about receivables, many loans and other debt instruments. However, amortized cost measurement needs to be supplemented with disclosure of fair value or other information. We agree that amortized cost should be applied only when it is consistent with the business model under which specific instruments are managed, but that this condition alone is not sufficient. We think that the idea of restricting amortized cost measurement to instruments with basic loan features shows promise but, as explained in response to Question 2, we do not think that the guidance proposed would achieve the appropriate categorization of instruments.

Members of our User Advisory Council are divided on whether amortized cost measurement provides the most decision-useful information for any debt instruments. While some members of this group advocate fair value measurement for all financial instruments, some members think that amortized cost measurement is appropriate for at least some, if not all, loans and receivables and that, in some cases, amortized cost measurement is appropriate for financial liabilities with disclosure of fair value and other information.

***Question 2 – Sufficiency of guidance on “managed on a contractual yield basis” and “basic loan features”***

Neither criterion is sufficiently well explained in the exposure draft to that ensure the IASB’s intentions are achieved or that the proposal would be consistently applied.

*Managed on a contractual yield basis*

We think that classification by business model is broadly appealing. It is easier to explain results in a meaningful way to stakeholders on a business unit level than on an instrument-by-instrument basis. However, we think that further clarification will be necessary for this criterion to be operational:

- We think that many will interpret the idea of “managing” on a contractual yield basis as holding all instruments in a unit to maturity or at least for the “foreseeable future”. Managing for yield

usually involves some level of trading to rebalance portfolios as contracts mature or are repaid. The concepts of “trading” and “held for trading” are not entirely clear under existing standards as applied to many business units. We think that some entities have used the available-for-sale category as a catch-all for instruments that could possibly taint held-to-maturity pools as well as portfolios that might be viewed as trading for the longer rather than shorter term. Without this intermediate category, we think the default classification would be trading. This could create unnecessary accounting mismatches and unintended limitations in practice in the use of amortized cost.

- We think that there will be interpretation difficulties with determining the breadth of a business unit. Preparers will likely argue for assessment at the level of the specific portfolio. Greater clarity is required. It would be desirable if the notion of a business unit here could be consistent with other groupings within the entity, such as those in IFRS 8 on reporting units below the segment level and IAS 36 regarding the allocation of goodwill to the level at which it is managed.

### *Basic loan features*

Although we agree that amortized cost measurement is appropriate for some debt instruments, we think that the guidance on basic loan features needs to be reworked to be operational:

- The guidance is too restrictive in terms of the interest rate-setting and resetting mechanisms, and repayment alternatives that are permitted. Many common basic loan structures would not qualify. We think that the guidance is intended to disallow leveraged instruments from amortized cost measurement, but as drafted it catches loans that provide borrowers with any flexibility. One example is the option to choose a different interest rate basis for each drawdown under a loan facility. This feature is not considered a basic loan feature under proposed paragraph B3(a)(iii), but is a common feature in commercial loans.
- We disagree that fair value measurement is always optimal for a financial instrument with an embedded derivative that is not clearly and closely related to its debt host. Despite its complexities, amortized cost measurement with an overlay of fair value measurement for bifurcated embedded derivatives is a useful model for communicating key performance metrics such as net interest margin while simultaneously capturing the effect of derivative components. Further, the amortized cost model allows lenders to report more clearly on the level of, and trends in, credit risk in their loan portfolios. Neither amortized cost nor fair value measurement address liquidity risk without additional disclosures.
- The proposal seems to be aimed at lenders but would clearly apply equally to borrowers. We think that in attempting to address recent market problems, it will inadvertently force reporting changes in non-financial entities that do not make sense. We think that the existing model for bifurcating derivatives embedded in liabilities is usually more useful than full fair value measurement. Insurers are uncertain whether funding instruments that provide the ability to suspend payment of interest in specified circumstances will continue to qualify for amortized cost treatment. It is also not completely clear how funding instruments issued by insurers that provide the ability to convert unpaid interest to shares in specified circumstances would be classified or measured.
- We disagree that the guidance on subordinated financial instruments is clear or consistent. The draft focuses on instruments issued by securitization vehicles but is illogical. When a

subordinated tranche is further subdivided, for example to improve marketability, the top tier of the new vehicle would qualify for amortized cost measurement. Draft paragraph B6 has created confusion; some constituents are interpreting it as requiring fair value measurement for virtually any subordinated instrument. We recommend that the IASB revisit the idea of both freestanding and embedded credit default swaps to ensure that various forms of credit protection are treated consistently.

- Bankers are concerned that the proposal would require significant procedural and systems modifications. A high level assessment suggests that instruments used in retail lending operations would continue to be reported at amortized cost but that many loans in commercial and corporate lending units would fail the basic loan feature criterion. Each facility would need to be reviewed on transition and systems overlays developed to handle the revised measurement requirements. Insurance companies would face similar operational challenges. The extent of the work required to implement the proposal makes it unlikely the standard would be implemented for December 2009 year-ends.

***Question 3 – Are other conditions more appropriate to determine amortized cost measurement?***

We agree that amortized cost measurement should be justified on the basis of the business model. If it is to incorporate characteristics of the instruments managed by the business unit as an overlay, we think that the guidance on basic loan features needs some work to address the issues raised in question 2. We have not had sufficient time to develop a workable alternative to that proposed in the Exposure Draft; in particular we are unable to answer parts (b) or (c) of the question. However, we think that the guidance should:

- not preclude amortized cost measurement of financial instruments solely on the basis of the existence of one or more embedded derivatives;
- specifically address the treatment of leverage including all credit protection features; and
- provide an unrestricted fair value option. (See responses to Questions 5 and 6.)

***Question 4a – Eliminate bifurcation of embedded derivatives***

We agree that bifurcating embedded derivatives is a very complicated aspect of the current standard. However, we are not convinced that eliminating the bifurcation of embedded derivatives necessarily improves decision-usefulness for all financial instruments. Some preparers are concerned that fair value measurement for some loans and debt instruments makes it difficult to assess interest margins between loan portfolios and funding instruments, or the cost of debt for borrowers.

Again, we note that entities can avoid the requirement to measure the entire instrument at fair value by creating two contracts. We think that this results in the accounting continuing to be driven by form. If the IASB is concerned about imposing the complexity of the bifurcation requirements on all constituents, we recommend retaining the current optional fair value treatment. In this case, as with hedge accounting, any complexity would be of the entity's own choosing.

We think that, with more time, the treatment of embedded derivatives should be considered for all contracts rather than only derivatives embedded in financial instruments. The embedded derivative requirements have been confusing for commodity contracts and insurance contracts, in which embedded derivatives are very common. Contracts containing embedded derivatives that are common in the insurance industry would be more difficult to measure in total at fair value than to bifurcate due, in part,

to their long-term nature. Industry representatives contend that more useful information is provided by bifurcation than would be possible with fair value measurement. We recommend that the IASB conduct a more comprehensive review of accounting for contracts with embedded derivatives that ensures consistency between the treatment of financial and non-financial contracts.

***Question 4b – Classification of subordinated interests***

As noted in our response to Question 2, we do not agree with the proposed approach to contractually subordinated interests. We think the guidance creates confusion about the treatment of subordinated interests in general and fails to address the credit risk in securitized products on a consistent or rational basis. Specifically, we think that paragraphs B6 and B8 are contradictory; they are essentially rules applicable to different classes of assets that can be partially circumvented by restructuring. We think that credit protection should be treated consistently across all financial instruments. Our recommendation to make bifurcation of embedded derivatives optional might be the basis for a solution.

***Question 5 – Should there be a fair value option to mitigate accounting mismatches?***

***Question 6 – Should availability of the fair value option be expanded?***

We think that an entity should be able to designate any financial asset or financial liability as measured at fair value, at initial recognition. We disagree that the fair value option should only be available to reduce or eliminate an accounting mismatch. We think that having multiple measurement bases creates confusion; the only viable single measurement model is fair value. Many constituents think that fair value measurement is the best measurement for all financial instruments. Entities that think it provides the best information should be entitled to adopt it.

We also think that the idea of accounting mismatches is difficult for many to grasp without additional guidance. Items such as insurance contracts and some provisions under IAS 37 are not measured at fair value, but the effects of these items can be offset to an extent by financial instruments that are measured at fair value.

The AcSB did not restrict the fair value option when it adopted a standard very similar to IAS 39 in Canadian GAAP. The prudential regulator imposed the IAS 39 criteria on regulated financial institutions, but the AcSB saw no reason to impose them on all entities. As far as we are aware, no practical difficulties have arisen. We also note that if the current proposals are adopted, an entity could structure an instrument to avoid the restriction on the use of the fair value option by incorporating an unrelated embedded derivative.

***Question 7 – Is reclassification ever appropriate?***

Reclassification is necessary to address changes in business models – it is inconsistent to require classification on the basis of a business model without allowing for changes in the model over time. Business model changes occur with some frequency in practice and can arise through such circumstances as business combinations, changes of corporate strategy and changes in market conditions. In fact, because the business model is such an important criterion in the classification decision, we believe reclassification should be required if the business model changes. Reclassification should be required on a prospective basis with extensive disclosure to ensure the rationale for, and effect of, any change is completely transparent. This point also emphasizes the need for clear guidance regarding the business model, which will ensure that this provision cannot be used to selectively apply the reclassification of individual instruments or small portfolios.

***Question 8 – Is fair value measurement for equity investments more decision-useful than cost less impairment?***

We think that fair value measurement accompanied by disclosure of the assumptions used in its determination and disclosure of the sensitivity of the measurement to changes in those assumptions provides the most decision-useful information for equity investments.

Financial statement users we consulted were divided on whether fair value measurement for all equity investments is more decision-useful than measurement at cost less impairment. Investments in junior mining companies were noted as an example of when fair value measurement of shares, by itself, fails to provide the most decision-useful information. Analysts noted that they were more interested in the extent and quality of a mine’s reserves and qualitative information about management than in fair value estimates. Preparers were concerned about the cost-effectiveness of providing fair value measurement, particularly for investees over which the entity has little influence. All were concerned with ensuring the transparency of any fair value information provided.

***Question 9 – Are there cost/benefit considerations that outweigh decision-usefulness of fair value information for equities and what impairment test is appropriate under those circumstances?***

Since determination of impairment for an equity investment measured at cost requires fair value measurement either directly or through use of a valuation technique, we do not think cost/benefit considerations are relevant. We think there are advantages to recognizing both decreases and increases in fair value as they occur.

***Question 10 – Would presenting income on strategic equity investments in OCI improve financial reporting?***

***Question 11 – Should the standard include an option to present income on untraded equities in other comprehensive income***

We think that presenting fair value changes, including dividends, for equity investments in other comprehensive income would not improve financial reporting. We disagree with providing the ability to create yet another category of other comprehensive income and make it permanent (i.e., non-recyclable). We are also not convinced that basing the distinction between “strategic” equity investments and other equity investments on whether the shares are held for trading makes sense.

Users think that what is essentially a second income statement is confusing. Preparers appreciate keeping volatility out of net income and avoiding the requirement to assess impairment but are concerned that amounts reported in other comprehensive income, especially dividends, would not be recycled. Insurance industry representatives noted that this option would be appealing for “investments backing capital”; available-for-sale is the category currently used for these investments. Both users and preparers noted that decisions are made on the basis of net income, not other comprehensive income and typically want recycling upon realization of revenues/gains and expenses/losses. We are also concerned that the use of other comprehensive income without recycling is inconsistent with the current position of the financial statement presentation project and is not based on any clear principle.

***Question 12 – Disclosures on early adoption***

Due to time constraints, we have not assessed the proposed disclosures in detail. However, they appear extensive and would seem to penalize entities that choose early adoption. Entities with the greatest

number of complex financial instruments will require such extensive systems modifications that early adoption would be unlikely. It seems unfortunate to penalize entities for moving early to what is, presumably, considered a better standard.

### ***Question 13 – Retrospective application***

We think that any changes to classification and measurement of financial instruments should be applied as of the beginning of the year in which the standard is adopted without restatement of comparative amounts. Restatement of comparative amounts could involve estimating fair values with hindsight for entities that decide to adopt the standard before its mandatory effective date. Even though entities presently disclose fair values of financial instruments, we recognize that less care is sometimes applied when determining disclosures. Similarly, for any financial instrument that is currently measured at fair value but would be measured at amortized cost under the new requirements, it would be difficult to determine amortized cost less impairment with hindsight. The effort to adopt IFRSs initially in 2011 is substantial for the Canadian entities that would be affected most by this proposal (and those in other countries adopting IFRSs at the same time as Canada). Restatement of comparative amounts would be operationally challenging to preparers and confusing to users of financial statements.

### ***Question 14 – Alternative approach***

### ***Question 15 – Variants to the alternative***

We disagree with the alternative approach because the determination of whether the instrument has basic loan features would disaggregate reporting for similar financial instruments. Further, the distinction between loans and receivables and other debt instruments is not necessarily useful. Although we think reporting could be improved by separating accrued interest from other fair value changes, we think the variants would be operationally difficult.

In general, because we think that all income should be reported in the income statement, we disagree with presenting components of income in other comprehensive income. There is no principle for determining which items belong in other comprehensive income and this would result in inconsistent and ad hoc reporting. The disaggregation proposed in the alternative is comparable to one of the less desirable features of available-for-sale classification in the current standard.

### ***Other comments***

Many preparers think that adopting this proposal would require considerable lead time in order to complete the necessary reviews of individual financial instruments and system changes. It would be very helpful for the IASB to continue to reassure constituents that the earliest mandatory application date would be January 1, 2012.

The insurance industry is expecting Phase II of the insurance project to become effective sometime in or after 2013. This will create another round of changes to reporting for that industry. Insurers are concerned that, if the current proposals are approved and mandatory in 2012, there will be a significant switch from fair value measurement to amortized cost in 2011 or 2012 and a reversion to fair value in 2013 or later on adoption of Phase II. We think that the transition provisions of Insurance Phase II should provide entities with the ability to revisit use of the fair value option made on adoption of this proposed standard, if it proceeds.

The transition provisions in paragraphs 26 through 32 have not been mirrored in the consequential amendments to IFRS 1. We think that if the transitional provisions are needed for existing IFRS

reporters, they are also needed for first-time adopters transitioning from standards very similar to IAS 39. If the relief provided in these paragraphs is substantive to an entity, it is unlikely to adopt the new standard on transition to IFRSs. This will complicate the transition to IFRSs for Canadian and other entities that will be adopting IFRSs during the period before this proposal becomes mandatory.