



**Tuesday, October 26**  
**2:30pm-4:00pm**

## **707 - What Corporate Counsel Need to Know About International Accounting Standard 39**

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## Faculty Biographies

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Mark T. Williams is currently executive-in-residence/lecturer in the finance and economics department at the Boston University School of Management. His major responsibility includes, course development and conducting risk management research.

Mr. Williams is a nationally recognized risk management expert. He has worked for regulated as well as un-regulated energy companies including PG&E Corp, Citizens Power and Edison Mission Energy. Major duties have included measuring, managing and reporting of the market, credit and operational risks associated with the trading of energy commodities e.g., power, coal, oil and natural gas. Measurement responsibilities have included the development of energy forward pricing curves and the daily marking-to-market of physical as well as complicated derivative type energy contracts with lengths of up to 25 years. Prior risk management experience also includes working at the Federal Reserve Bank (San Francisco & Boston) and as a bank trust officer. In these various roles he had been responsible for pricing derivative swap transactions, evaluating mark-to-market processes, examining trust investment portfolios, credit loan portfolios, level of prudent asset allocation and overall risk/returns. While at the Federal Reserve Bank he also served as the lead trust examiner for JP Morgan-California and focused on trading, investment and off-balance sheet risk.

In addition to teaching, Mr. Williams is also engaged in risk management and investment consulting to Fortune 500 Companies as well as to large net-worth individuals.

**Deloitte.**

Changes to IAS 39:  
IFRS 9

Oliver L. Kuehberger  
Deloitte Financial Advisory Services LLP

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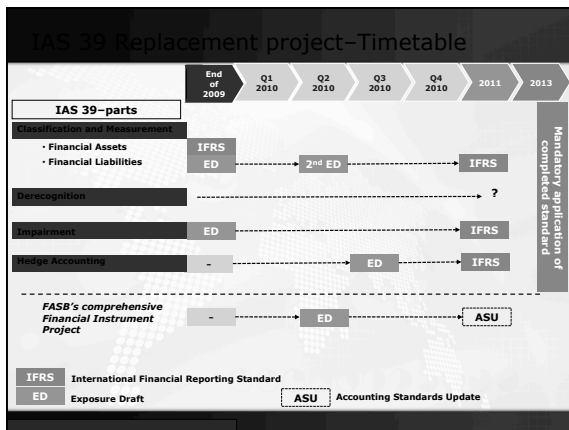
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Classification Categories – General Principles

Amortized Cost	➤	Instruments that an entity holds for purposes of collecting contractual cash flows (the business model test) and whose contractual cash flows represent solely principal and interest payments (the cash flow characteristic test)
Fair Value through Profit/Loss ("FVTPL")	➤	All instruments that do not meet the amortized cost criteria <i>plus</i> An entity may irrevocably elect FVTPL for amortized cost instruments that alleviate an accounting mismatch
Fair Value through OCI ("FVTOCI")	➤	An entity may irrevocably elect FVTOCI (vs. FVTPL) for equity instruments that are not held for trading

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### Amortized Cost – Business Model Test

**Business Model Test:**

Is the financial asset held within a business model whose objective is to hold assets in order to collect contractual cash flows?

- Business model test applies at a business unit or portfolio level, not at an instrument level
- Business model objective is determined by key management personnel, but is not based on intent for individual instruments
- Business model objective is observable through how an entity is managed and the type of information provided to key management personnel
- An entity may have multiple business models (e.g., retail banking vs. investment banking)
- Financial assets generally need not be held until maturity in order to be eligible for amortized cost classification (e.g., assets sold if entity needs to fund capital expenditures)

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### Cash Flow Characteristics Test - Summary

- Entity needs to classify a financial asset on the basis of its contractual cash flow characteristics

Contractual Cash Flows

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Repayment of Principal

+

Interest on principal outstanding

Time value of Money  
Credit Risk

Assessment is in denomination currency

- Leverage may increase variability of contractual cash flows to an extent that they lack the economic characteristics of interest. If so, the instrument is not eligible for amortized cost measurement
  - Examples include all derivatives, such as stand-alone options, swaps, forward contracts

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### Amortized Cost –Cash Flow Characteristics Test

**Cash Flow Characteristics Test:**

Do the terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest?

- Interest includes consideration for the time value of money and for credit risk associated with the principal outstanding only
- Non-genuine (i.e., non-substantive) terms should be ignored for purposes of applying the test
- Financial assets with leverage do not qualify
- For floating interest rates, the frequency of reset must match the period over which the floating rate is determined (e.g., monthly resets for 1M LIBOR)
- Certain prepayment and extension options are permissible
- For non-recourse debt instruments, one must look through to the underlying assets to apply the test
- Subordinated instruments are subject to further restrictions

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### FVTPL Classification Principles

Fair Value through Profit/Loss ("FVTPL")

➤

All instruments that do not meet the amortized cost criteria  
*plus*  
All instruments for which an entity irrevocably elected FVTPL

General Principles:

- Includes instruments (a) whose contractual cash flows do not represent solely principal and interest payments or (b) that are held as part of a business model with an objective other than to collect contractual cash flows
- An entity may irrevocably elect to classify as FVTPL an amortized cost instrument (at initial recognition) if doing so eliminates or significantly reduces an accounting mismatch

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### FVTOCI Classification Principles

Fair Value through OCI ("FVTOCI")

➤

An entity may irrevocably elect FVTOCI (vs. FVTPL) for equity instruments that are not held for trading

General Principles:

- For equity instruments only
- An instrument-by-instrument election
- The instrument must **not** be held for trading
- Election must be made at initial recognition of instrument
- Election is irrevocable

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### Reclassification

General Principles:

- Financial assets must be reclassified when the objective of an entity's business model for managing those assets changes
- Reclassification is expected to be **very infrequent**
- Reclassifications are applied prospectively

Measurement upon Reclassification:

Fair Value

Fair value at reclassification date becomes new carrying amount

➔

Measured at fair value on the reclassification date, with any difference between fair value and its previous carrying amount recognized in earnings

Amortized Cost

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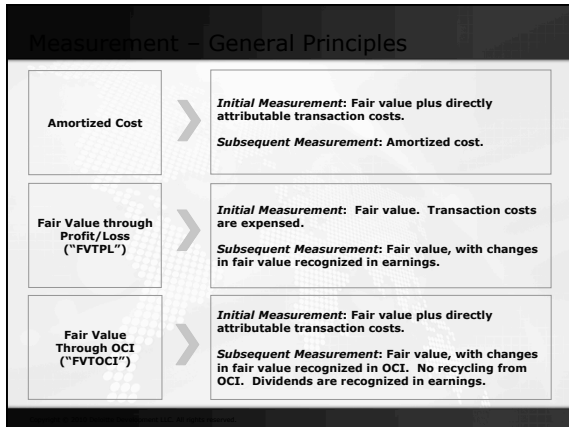
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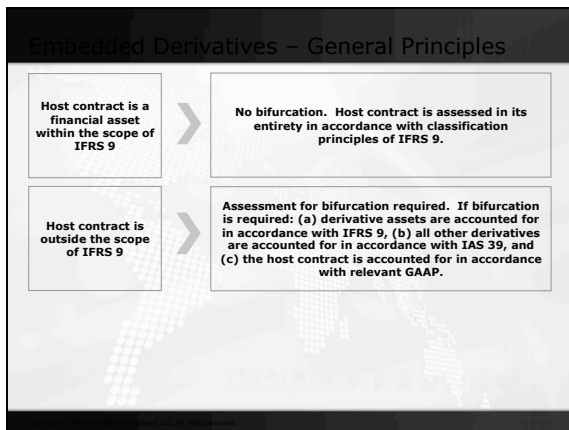
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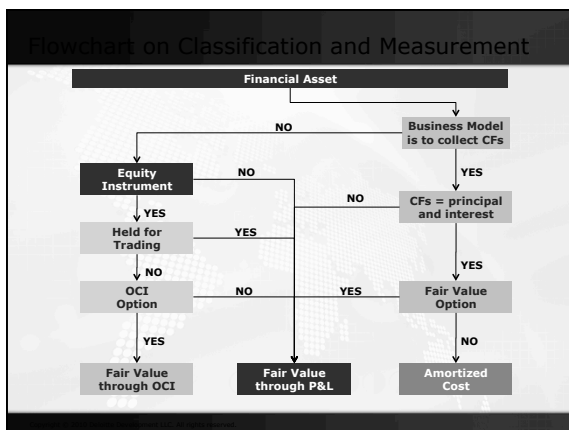
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**Effective Date and Transition**

Effective Date:

- Annual periods beginning on or after January 1, 2013
- Earlier application is permitted

Transition:

- Must be applied retrospectively
- Comparative information not required to be presented if adopted by January 1, 2012

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**Session 707: What Corporate Counsel Need to Know About International Accounting Standard 39****Presentation: Changes to IAS 39: IFRS 9 – Oliver Kuehberger, Deloitte Financial Advisory Services LLP****Overall Aims:**

- To introduce the key concepts of IFRS 9, including classification and measurement of financial assets, and to address key U.S. GAAP / IFRS differences in those areas.

**Key Learning**

- IFRS 9 outlines the three classification categories of financial assets
- IFRS 9 provides initial and subsequent measurement guidance for each of the three classification categories for financial assets

**Knowledge Assumed**

- The U.S. GAAP principles for classification and measurement of financial assets.

**Key Technical References**

- IFRS 9, *Financial Instruments*
- IAS 39, *Financial Instruments: Recognition and Measurement*

**Title Slide**

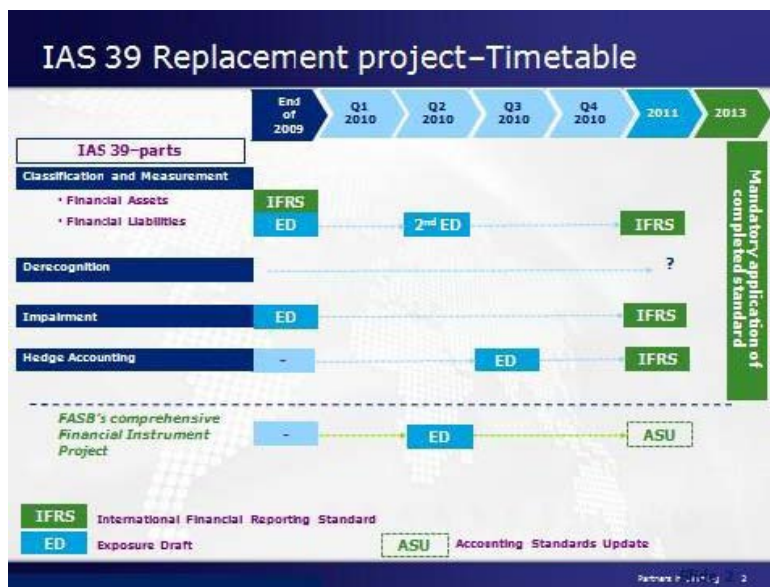
The objective of today's presentation is to introduce the concepts presented in IFRS 9, *Financial Instruments*, specifically the classification and measurement of financial assets.

IFRS 9 is a unique standard in the sense that it is a work in progress. Over the course of 2010 and the first half of 2011, the IASB will be working to "complete" the remaining chapters of IFRS 9, which will address other areas of accounting for financial instruments, including classification and measurement of financial liabilities, hedge accounting, impairment, and derecognition. Once completed, IFRS 9 is intended to replace IAS 39 in its entirety.

Given its current incomplete state, IFRS 9 refers frequently to guidance found within IAS 39 to supplement those areas that it does not yet explicitly address.



## Slide 1



In March 2009, the FASB and the IASB announced that they will fast-track their efforts to reduce complexity in the accounting for financial instruments by replacing existing requirements with a simplified and improved approach. Although this is a joint project, each Board has decided to separately deliberate the issues and subsequently seek to reconcile any differences in its tentative decisions. Although this is a joint project, each Board has decided to separately deliberate the issues and subsequently seek to reconcile any differences in its tentative decisions.

The issuance of IFRS 9 represents the completion of the first phase of the IASB's project to replace IAS 39. The project addresses classification and measurement of financial assets as well as the accounting for financial liabilities, recognition and measurement of impairments, hedge accounting and derecognition. The IASB expects to replace the remaining portions of IAS 39 by mid 2011, except derecognition, which was recently postponed.

FASB is also currently working on an extensive project to overhaul the accounting for financial instruments under U.S. GAAP from which a comprehensive exposure draft addressing classification and measurement, impairment, and hedge accounting was issued in May 2010. However, given that the FASB's financial instruments project is still ongoing and the end result is not yet known, we will not address potential changes to

U.S. GAAP requirements at this time in details but will highlight the key concepts in the IFRS/US GAAP comparison at the end of this presentation.

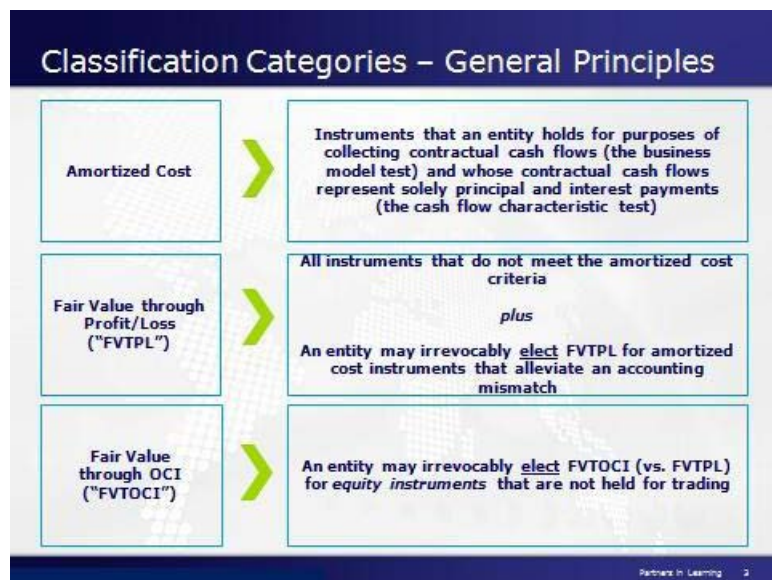
With respect to recognition of financial assets, IFRS 9 makes no change to the recognition requirements previously required under IAS 39. That is, financial assets should be recognized when an entity becomes party to the contractual provisions of the financial asset.

As an example, when an entity invests in a debt security, it becomes party to the contractual principal and interest payments of that security. As such, it is required to recognize the financial asset at that time.

Given that IFRS 9 did not change the recognition guidance previously required by IAS 39, we will not address recognition any further.

The remainder of the presentation will focus on the core principles of the classification and measurement of financial assets under IFRS 9, which, as you will see, are inextricably connected to one another.

## Slide 2



IFRS 9 provides three classification categories for financial assets, as shown here.

The amortized cost classification is reserved for financial assets that meet two criteria. First, the financial asset must be held in a business model whose objective is to hold the asset for purposes of collecting its contractual cash flows. Second, the terms of the financial asset must represent principal and interest payments only. If those two criteria are met, the asset is required to be classified as amortized cost.

The fair value through profit or loss, or FVTPL, classification is a bit simpler. The general rule is that all financial assets that do not meet the two criteria for the amortized cost classification are required to be classified as FVTPL. In addition, an entity may elect FVTPL for financial assets that would otherwise be classified as amortized cost if doing so would alleviate an accounting mismatch.


Finally, IFRS 9 permits an entity to elect the fair value through OCI, or FVTOCI, classification for financial assets that are equity instruments and that are not held for trading. The FVTOCI election is irrevocable.

## Slide 3

## Amortized Cost - Business Model Test

*Business Model Test:*

Is the financial asset held within a business model whose objective is to hold assets in order to collect contractual cash flows?



- Business model test applies at a business unit or portfolio level, not at an instrument level
- Business model objective is determined by key management personnel, but is not based on intent for individual instruments
- Business model objective is observable through how an entity is managed and the type of information provided to key management personnel
- An entity may have multiple business models (e.g., retail banking vs. investment banking)
- Financial assets generally need not be held until maturity in order to be eligible for amortized cost classification (e.g., assets sold if entity needs to fund capital expenditures)

Partners in Learning 4

For a financial asset to be classified as amortized cost, two criteria must be met. The first of these criteria is that the financial asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows. We'll refer to this criterion as the "business model test."

The business model test is not meant to be applied at an individual instrument level. Rather, the business model test applies at a higher level of aggregation, such as at a portfolio level or a business unit level. For example, when applying the business model test, one **should not** ask whether the intent for holding that specific asset is to collect its contractual cash flows. Rather, one should ask whether the asset is being held in a business model (e.g., a portfolio or a business unit of the reporting entity) whose objective is to hold the assets in order to collect their contractual cash flows.

The objective of a business model is determined by an entity's key management personnel (for example, a CEO, CFO, CRO, etc.). IFRS 9 explains that the objective of a business model is not based on intent, but rather is observable through how an entity manages the model and the type of information provided to key management personnel. It is also important to point out that a reporting entity is permitted to have multiple business models. As an example, consider a banking institution with two divisions – a retail banking unit that generally holds assets to maturity or near maturity and an investment banking unit that holds assets for sale or trading purposes.

The last item to highlight is that the business model test does not require that assets be held to maturity in order to qualify for the amortized cost classification. Some sales of financial assets are permitted. For example, an entity may sell a financial asset if:

- the financial asset no longer meets the entity's investment policy (e.g., the credit rating of the asset declines below that required by the entity's investment policy);
- an entity adjusts its investment portfolio to reflect a change in expected duration (i.e., the expected timing of payouts); or
- an entity needs to fund capital expenditures.

Example: Sale of assets to minimize credit losses

Entity Q is a financial institution that holds for the long term a portfolio of debt investments with a high credit quality. The business expects to collect the contractual cash flows on the instruments, however, the business is subject to internal guidelines that requires that if debt instruments fall below a predetermined credit rating and have a fair value below 60 per cent of their par value (a 'stop loss feature') the business is required to sell the assets.

Examples of business models in which the objective is **not** to hold instruments to collect the contractual cash flows include the following:

- Where an entity manages the performance of a portfolio of financial assets with the objective of realizing cash flows from the sale of assets.
- A portfolio of financial assets that is managed, and whose performance is evaluated, on a fair value basis.
- A portfolio of financial assets that meets the definition of held for trading.

#### Slide 4

**Cash Flow Characteristics Test - Summary**

- Entity needs to classify a financial asset on the basis of its contractual cash flow characteristics

- Leverage may increase variability of contractual cash flows to an extent that they lack the economic characteristics of interest. If so, the instrument is not eligible for amortized cost measurement
  - Examples include all derivatives, such as stand-alone options, swaps, forward contracts

Partners in Learning 4

#### Understanding the Cash Flow Characteristics Test:

First, we need to understand what IFRS 9 means by interest.

Another thing to keep in mind is that, when assessing the characteristics of a financial asset, all non-genuine (or non-substantive) terms are to be ignored. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

One feature that results in a financial asset not passing the cash flow characteristics test is leverage. Leverage, which is regarded as a multiple greater than one, is a feature in certain financial assets that increases the variability of cash flows of the instrument in such a way that the resulting cash flows do not represent interest payments.

As an example, consider a debt instrument that has a stated interest rate of LIBOR multiplied by 1.3. The 1.3 multiple "levers up" the LIBOR rate, or, said differently, increases the variability of the cash flows of the debt instrument, resulting in cash flows that do not represent compensation solely for the time value of money and credit risk.

Another feature that would result in a financial asset failing the cash flow characteristics test is where the frequency of reset of a floating interest rate does **not** match the period over which the floating rate is determined. This is because a mismatch in reset frequency and the period over which the rate is determined results in an off-market interest rate that would include compensation for something other than the time value of money and credit risk.

There are three more items that need discussing, but only at a high level. First, certain **prepayment and term-extension options** would not result in a financial asset failing the cash flow characteristics test. Generally speaking, these types of features are permitted so long as the exercise of the option is not contingent on something other than a credit-risk-related event and results in contractual cash flows that represent payments of principal and interest.

Second, **for non-recourse debt instruments**—that is, instruments where a creditor's claim is limited to specific assets

of the debtor—IFRS 9 requires that a reporting entity “look through” the instrument to the assets serving as collateral to determine whether the contractual cash flows from the underlying assets represent solely principal and interest. And lastly, IFRS 9 outlines certain considerations for **instruments featuring subordination**. If certain criteria are not met, subordination may disqualify a financial asset from passing the cash flow characteristics test. Given the specificity of these three items, we will not discuss them in further detail. However, I do want to make you aware that IFRS 9 addresses those types of situations.

## Slide 5

**FVTPL Classification Principles**

Fair Value through  
Profit/Loss  
("FVTPL")

➤

All instruments that do not meet the amortized cost  
criteria

*plus*

All instruments for which an entity irrevocably  
elects FVTPL

**General Principles:**

- Includes instruments (a) whose contractual cash flows do not represent solely principal and interest payments or (b) that are held as part of a business model with an objective other than to collect contractual cash flows
- An entity may irrevocably elect to classify as FVTPL an amortized cost instrument (at initial recognition) if doing so eliminates or significantly reduces an accounting mismatch

Partners In Learning 13

In contrast to the rules associated with the amortized cost classification, the fair value through profit or loss (or “FVTPL”) classification is fairly straightforward. In fact, you could view it as a “default” category. What this means is that if an instrument fails to meet the two amortized cost criteria – i.e., it does not pass either the business model test or the cash flow characteristics test – it must be classified as FVTPL.

An exception to this general rule is that IFRS 9 allows an entity to irrevocably elect the FVTPL classification for instruments that would otherwise be classified as amortized cost if doing so would alleviate an accounting mismatch. *Accounting mismatch* refers to a situation where a financial asset is measured at amortized cost while a related liability is being measured at fair value.

## Slide 6

## FVTOCI Classification Principles

Fair Value  
through OCI  
("FVTOCI")

➤

An entity may irrevocably elect FVTOCI (vs. FVTPL) for equity instruments that are not held for trading

General Principles:

- For equity instruments only
- An instrument-by-instrument election
- The instrument must **not** be held for trading
- Election must be made at initial recognition of instrument
- Election is irrevocable

Partners in Learning 14

The second exception to this general rule leads us to our last classification category.

The fair value through other comprehensive income (or "FVTOCI") classification is an optional classification category reserved for financial assets that are equity instruments and that are not considered held for trading. Stated a bit differently, IFRS 9 provides an instrument-by-instrument election that permits an entity to measure changes in the fair value of a financial asset through OCI so long as the financial asset is an equity instrument (e.g., share of common stock) and would not be considered held for trading.

As noted earlier, this is an exception to the FVTPL classification, which would otherwise require the changes in fair value of these instruments to be recognized in earnings. The major benefits of this classification will be discussed later when we address the measurement guidance related to each classification category.

A financial asset or financial liability is held for trading if: [IAS 39.9]

- (a) it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
- (b) on initial recognition, it is 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; or
- (c) it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

A couple of things to keep in mind about the FVTOCI classification are: (1) the election is irrevocable; and, (2) the election is available only at initial recognition. If the equity investment is designated as FVTOCI, all gains or losses except dividend income, which is recognized in profit or loss, are recognized directly in equity without any reclassifications to profit or loss even if the investment is subsequently sold, unless they represent a return of the cost of the investment.

## Slide 7

## Reclassification

General Principles:

- Financial assets must be reclassified when the objective of an entity's business model for managing those assets changes
- Reclassification is expected to be **very infrequent**
- Reclassifications are applied prospectively

Measurement upon Reclassification:

Partners In Learning 15

Quickly, to recap each classification:

Amortized cost is for instruments that pass both the business model and cash flow characteristics tests;

FVTPL is for instruments that fail either the business model or cash flow characteristics test (as well as for instruments that would otherwise be classified as amortized cost if doing so alleviates an accounting mismatch and an entity elects to classify it as FVTPL); and,

FVTOCI is an elective classification for equity instruments that would not be considered held for trading.

Before we wrap up our discussion of classification, let's quickly visit the rules of reclassification.

Under IFRS 9, reclassification occurs only if the business model that a financial asset is held in changes. To emphasize, the only circumstance under which a financial asset would be reclassified is if a change is made to the business model in which the asset is held.

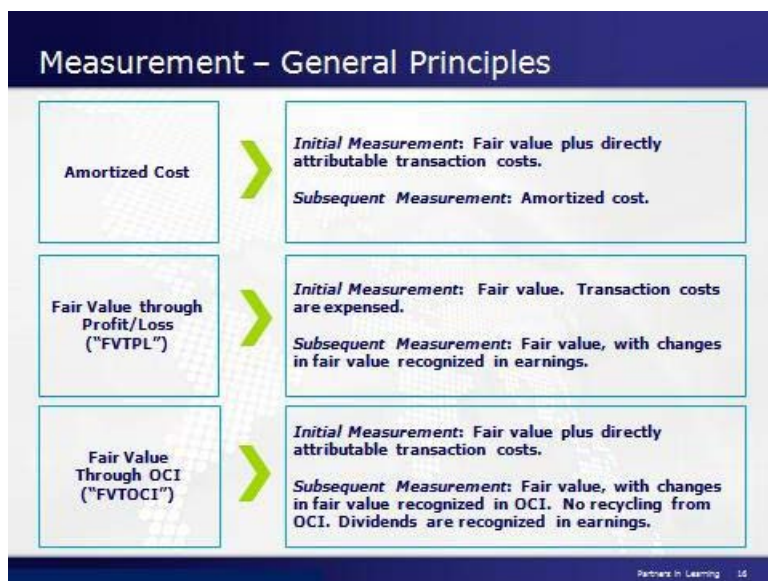
For example, consider a financial services firm that decides to shut down its retail mortgage business. Prior to the decision to terminate the retail business, the objective of that unit was to hold financial assets for purposes of collecting contractual cash flows. However, after the decision to close down the retail mortgage business was made, the retail business no longer originates new mortgages and the financial services firm is actively marketing its mortgage loan portfolio for sale. Given that the firm no longer holds the retail mortgages to collect their contractual cash flows, the mortgage loans would no longer be eligible for the amortized cost classification and must (**note that the reclassification is not optional**) reclassify the mortgages to FVTPL.

It's important to note that such changes are expected to be very infrequent. In addition, these changes to an entity's business models must be determined by the entity's senior management as a result of external or internal changes **and** must be significant to the entity's operations and demonstrable to external parties. As such, the following would not be considered changes in business model: [IFRS 9:B5.11]

1. a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).
2. a temporary disappearance of a particular market for financial assets.
3. a transfer of financial assets between parts of the entity with different business models.

As shown on the slide, reclassification occurs at fair value. At the time of reclassification, the fair value of the financial asset is determined and becomes its new carrying amount. And in the case of a financial asset previously classified as amortized cost, any difference between the carrying amount of the asset and its fair value is recognized immediately in earnings.

## Slide 8



Now that we've addressed the classification rules of IFRS 9, let's move on to the measurement guidance for each of the classification categories.

Luckily, the titles of the classification categories "say it all"... that is, financial assets classified as amortized cost are subsequently measured at amortized cost whereas financial assets classified as either FVTPL or FVTOCI are subsequently measured at fair value. Of course, for financial assets classified as FVTPL, changes in fair value are recognized in earnings whereas, for financial assets classified as FVTOCI, changes in fair value are recognized in OCI. I should also point out that for financial assets classified as FVTOCI; amounts recorded in OCI remain in OCI. That is, IFRS 9 does not permit entities to "recycle" amounts recorded initially in OCI into earnings. The benefit of no recycling is that instruments classified as FVTOCI need not be tested for impairment because the amounts in OCI are permanently deferred in equity.

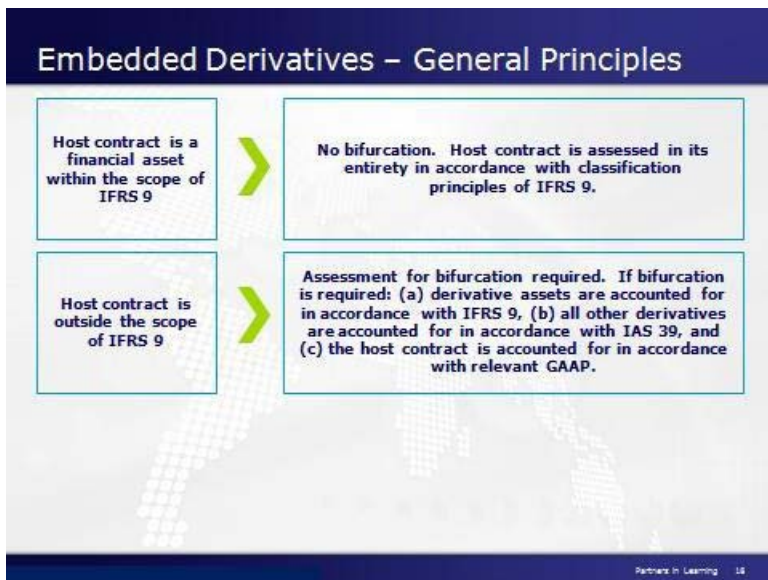
Note that this differs from U.S. GAAP, which requires amounts recorded in OCI for available for sale securities to be recycled into earnings upon a sale, settlement, or impairment.

Keep in mind, however, that dividends received from financial assets classified as FVTOCI **are** recorded in earnings. With respect to initial measurement, all financial assets are initially measured at fair value. In addition, for financial assets classified as either amortized cost or FVTOCI, directly attributable transaction costs (which we will discuss on the following slide) should be included in the initial measurement of the asset. In contrast, for financial assets classified as FVTPL, transaction costs are immediately expensed.

Those are "the basics" of measurement under IFRS 9.



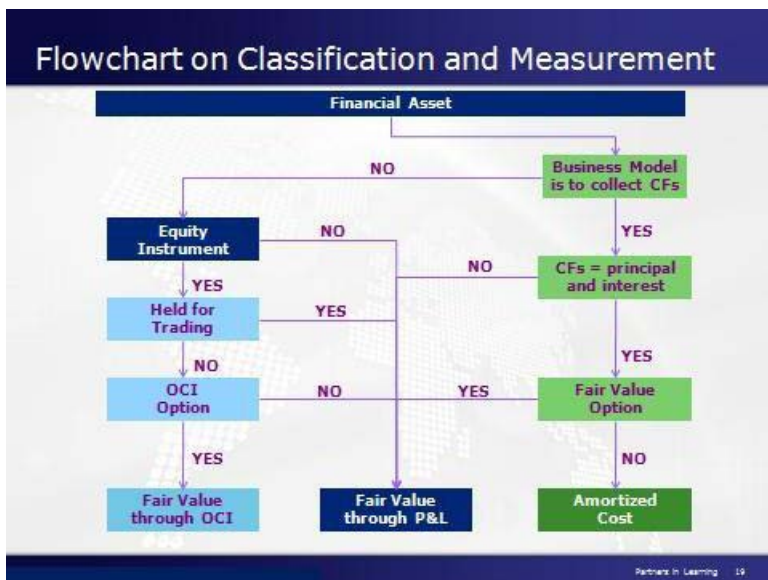
Slide 9



High level overview of embedded derivatives:

IFRS 9 does not retain the embedded derivative concept that exists in IAS 39 for hybrid contracts in which the host contract is a financial asset within the scope of IFRS 9. Consequently, embedded derivatives that under IAS 39 would have been separately accounted for at fair value because they were not closely related to the financial host asset will no longer be separated. Instead, the contractual cash flows of the hybrid financial asset are assessed in their entirety and the hybrid financial asset as a whole is required to be classified as FVTPL if any of its cash flows do not represent payments of principal and interest. Because IFRS 9 only applies to assets within the scope of IAS 39, the embedded derivative concept (that is, bifurcation of embedded derivatives that are not closely related to the host contract), at least for now, is retained for all hybrid financial liabilities and asset host contracts that are outside the scope of IAS 39.

Slide 10



The flowchart summarizes the decision tree for classification and measurement of financial assets according to IFRS 9.

## Slide 11

**Effective Date and Transition**

Effective Date:

- Annual periods beginning on or after January 1, 2013
- Earlier application is permitted

Transition:

- Must be applied retrospectively
- Comparative information not required to be presented if adopted by January 1, 2012

Partners In Learning 20

Generally, there would not be a need to discuss effective date and transition guidance of a standard in a training session like this. However, given that IFRS 9 is not yet mandatory for all entities applying IFRS, we thought it would be beneficial to briefly discuss this information with you.

First, let's talk about the effective date of IFRS 9. IFRS 9 requires that its provisions be adopted by reporting entities no later than the first annual reporting period beginning on or after January 1, 2013. However, IFRS 9 does permit early adoption. If an entity decides to early adopt the standard, it must disclose that fact. The business model assessment will be made as of the date of initial application.

In addition, at adoption, IFRS 9 requires retrospective application of its provisions in accordance with IAS 8. I should also note that if an entity adopts IFRS 9 prior to January 1, 2012, comparative disclosures are not required.

### Appendix:

#### **Key differences to US GAAP**

To wrap up, let's discuss some of the key differences between IFRS 9 and related guidance in current US GAAP as well as classification and measurement model covered by the FASB exposure draft issued on May 26, 2010.

Currently, the two boards' approaches differ in important respects. For instance, under the FASB's proposed ASU, more financial instruments would be measured at fair value than under current US GAAP and IFRSs.

**Classification** – As we just learned, IFRS 9 outlines three classification categories for financial assets within its scope – amortized cost, FVTPL, and FVTOCI. In contrast, US GAAP has numerous classification categories for financial assets. And which classification is appropriate depends on the type of the financial asset. For example, under US GAAP, an investment in a debt security could be classified as available for sale, held to maturity, or trading. But, a mortgage loan would be classified as either held-for-investment or held-for-sale.

FASB's proposed ASU outlines six categories of financial assets and financial liabilities: -FVTPL (default category); Amortized cost; FVTOCI; Redemption value (required for certain redeemable investments); Remeasurement approach for core deposits through net income; Remeasurement approach for core deposits through OCI (elective).

**Criteria for Amortized Cost Measurement** – Under IFRS 9, financial assets are measured at amortized cost only if the financial asset passes both the business model and cash flow characteristics tests. Otherwise, the asset must be measured at fair value.

Under current US GAAP guidance, financial instruments classified as Held-to-Maturity (HTM) are required to be measured at amortized cost. In addition, loans held for investment are also measured at amortized cost.

Under the FASB's proposed model, only an entity's own debt would be measured at amortized cost if the debt qualifies for the FVTOCI classification and would alleviate an accounting mismatch.

**Criteria for FVTOCI Classification** – Under IFRS 9, an entity can elect to classify a financial asset as FVTOCI if the asset is an equity instrument that is not held for trading. The election must be made at initial recognition and is irrevocable.

Under current US GAAP guidance, financial instruments classified as Available-for-Sale (AFS) are required to be measured at fair value, with changes in fair value recorded to OCI.

Under the FASB's proposed model, an entity may elect to classify a financial asset or financial liability as FVTOCI if it meets all of the following criteria:

- **Cash flow characteristics** – it represents a debt instrument that cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initially recorded investment, other than through its own choice
- **Business strategy** – the business strategy for the instrument is to collect or pay the related contractual cash flows.

**No embedded derivative required to be separated** – It is not a hybrid instrument for which an embedded derivative is required to be separated under existing U.S. GAAP. **Reclassification** – IFRS 9 is fairly restrictive with respect to when reclassification of financial assets is appropriate. In fact, reclassification is limited to when a change in business model occurs. And IFRS 9 emphasizes that such changes are expected to occur very infrequently.

In contrast, US GAAP—generally speaking—more readily permits reclassification between classification categories, although certain restrictions still do apply. For example, there are strict rules around when an asset classified as HTM may be reclassified.

Under FASB's proposed model, reclassifications are not permitted.

**Reclassification of Accumulated OCI to Net Income** – Under IFRS 9, amounts recorded in OCI for a financial asset designated as FVTOCI are permanently deferred in equity. Said differently, under IFRS 9, amounts recorded in OCI are never “recycled” into earnings.

In contrast, under US GAAP as well as the FASB's proposed model, amounts recorded in OCI are “recycled” to earnings when realized. For example, consider an investment in an equity security classified as available for sale under US GAAP. Unrealized changes in fair value are recorded in OCI in accordance with ASC 320. Then, upon the sale of that investment, the amount recognized in OCI is transferred into earnings as part of the journal entry recorded upon the sale. One practical result of the difference we just discussed is that financial assets classified as FVTOCI are not tested for impairment under IFRS 9 because all fair value changes associated with these instruments are permanently recorded in equity. In contrast, AFS securities under both current US GAAP and the FASB's proposed model are required to be tested for impairment.

**Fair Value Option** – IFRS 9 permits an entity to elect the FVTPL classification for amortized cost instruments only if doing so would alleviate an accounting mismatch.

Under current US GAAP guidance, an entity may elect to measure a financial asset at fair value when the asset is initially recognized, with certain exceptions. Under the FASB's proposed model, there is no explicit fair value option.

**Embedded Derivatives** – IFRS 9 does not retain the embedded derivative concept that exists in IAS 39 for hybrid contracts in which the host contract is a financial asset within the scope of IFRS 9. Consequently, embedded derivatives that under IAS 39 would have been separately accounted for at fair value because they were not closely related to the financial host assets will no longer be separated. Instead, the contractual cash flows of the hybrid financial asset are assessed in their entirety and the hybrid financial asset as a whole is required to be classified as FVTPL if any of its cash flows do not represent payments of principal and interest.

Under current US GAAP guidance, the embedded derivative is required to be bifurcated and accounted for separately from the host instrument if it meets the requirements under ASC 815. Under the FASB's proposed model, hybrid

financial contracts with an embedded derivative which is bifurcated per ASC 815 would be measured in their entirety at FVTPL. Hybrid financial contracts can be classified at FVTOCI if the embedded derivative is not required to be bifurcated.

# Implications of GAAP Conversion

John E. P. Reynolds, C.A., LL.B.

MONTRÉAL

OTTAWA

TORONTO

EDMONTON

CALGARY

VANCOUVER



# Overview

- I. legal documents
- II. planning & transition

# Part I:

## Effect of GAAP choice made in legal documents

1. financial measures specified in agreements
2. requirement to report specific financial information to a counterparty under an agreement
3. internal and external financial reporting



# Contractual provisions with GAAP based financial measures

- debt covenants in credit facilities
- compensation arrangements
- M&A - financial performance based adjustment provisions in acquisition agreements
- commercial agreements
  - lease terms based on financial performance measures
  - royalties based on financial performance measures
  - restrictions on distribution of cash





# Requirement to provide certain GAAP based financial information

- is old GAAP financial information required after conversion?
- will old GAAP financial statements be available after conversion?
- is a reconciliation of new GAAP to old GAAP practicable or reliable?
- if you are providing information - will the counterparty want other information?
- if you are receiving information - will you receive the information you require?

# Disclosure of GAAP conversion: the Canadian experience

- Canada to adopt IFRS for 2011 (2010 comparatives required)
- May 2008, securities administrators issued staff notice 52-320 identifying disclosure expected for interim and annual MD&A
  - accounting policies permitted
  - accounting policies to be implemented (if decisions made)
  - information technology and data systems
  - internal controls over financial reporting
  - disclosure controls and procedures
  - financial reporting expertise/training requirements
  - business activities that may be affected by GAAP measures
- in 2010 quantitative effects of GAAP conversion to be disclosed



# Looking back: review of GAAP definitions in existing agreements

- will the GAAP standard follow the GAAP conversion to new GAAP or will old GAAP remain the standard?
- is the GAAP definition clear?
- interpretation of the GAAP definition:
  - plain language of agreement
  - other indications of the parties' intentions
  - older versus newer agreements
- what are the effects on GAAP-based financial measures and reporting obligations?



## GAAP definitions:

- *"GAAP" means generally accepted accounting principles in effect on the date hereof*
- *"GAAP" means those accounting principles which are recognized as being generally accepted in the United States from time to time*
- *"GAAP" means United States generally accepted accounting principles, applied on a consistent basis with past practices*



# Planning Ahead: agreements made after conversion to IFRS expected, but before implementation

- will the agreement have a US GAAP standard?
  - reconcile back to US GAAP from IFRS after adoption
- will the agreement set IFRS as the standard?
  - reconcile to IFRS from US GAAP until adoption of IFRS
- will both standards be used?
  - setting a measure under both US GAAP and IFRS from the outset



# Contemplating GAAP change: example of agreement to agree

- a) *All calculations for the purposes of determining compliance with the financial ratios and covenants shall be made on a basis consistent with GAAP in existence as at the date of this Agreement.*
- b) *Upon the adoption of IFRS, the parties shall negotiate in good faith to revise such ratios and covenants to give effect to the intention of the parties under this Agreement at the date hereof.*
- c) *In the event that such negotiation is unsuccessful, all calculations thereafter made for the purposes of determining compliance with the financial ratios and covenants shall be made on a basis consistent with GAAP in existence at the date hereof.*



# Contemplating GAAP change: example to avoid GAAP change

- *Each of the financial measures for a particular quarter shall be calculated from the Corporation's relevant financial statements prepared in accordance with GAAP applied consistently with the Corporation's financial statements for the year ended, without the adoption of IFRS and thereafter adjusted, in the case of any financial statements reflecting the adoption of IFRS, to remove the effects of the adoption of IFRS.*

## Part II:

# Transition issues for GAAP conversion

- plan for conversion (2-3 years)
- timeline (early adoption?)
- sufficient personnel/training of personnel
- systems / technology
- budgeting
- internal reporting / internal controls
- external communication of transition
- auditor involvement
- involvement of other consultants





# Training required

- accounting personnel
- management / executive team
- audit committee
- board of directors
- investor relations
- analysts and investors



# Governance matters

- audit committee
  - qualification of audit committee
  - composition of audit committee
  - continuing education
- board of directors
  - same issues



# Panel Discussion

- Mark T. Williams, Boston University
- Oliver L. Kuehberger, Deloitte
- John E. P. Reynolds, FMC Law

## ACC IAS 39 Panel

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**Boston University**  
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## International Accounting Standards

- Globalization and the need for consistency in financial reporting has spurred growth of international accounting standards
- US GAAP and International Financial Reporting Standards (IFRS) are converging
- The financial crisis of 2008 has accelerated wider support for accounting unity
- Convergence will require multiple phase-in periods

## History - International Accounting Standards

- IAS 39 - Financial Instruments: Recognition & Measurement is an example of this global trend
- IAS 39 is far-reaching, applying to a broad array of business activities
- This initial standard was released December 1998, and since has included numerous revisions

## History - IAS 39

- IAS 39 Objective: Establish a common methodology for recognizing and measuring
  1. Financial assets
  2. Financial liabilities
  3. Various contracts used to buy/sell non-financial items

## IAS 39

- Adopting IAS was more than a compliance exercise – it fundamentally changed the level of detailed reporting and created a new set of revealing numbers
- Scrutiny by shareholders, board members, analysts and other stakeholders over the numbers and risk management strategies applied have increased

## IAS 39

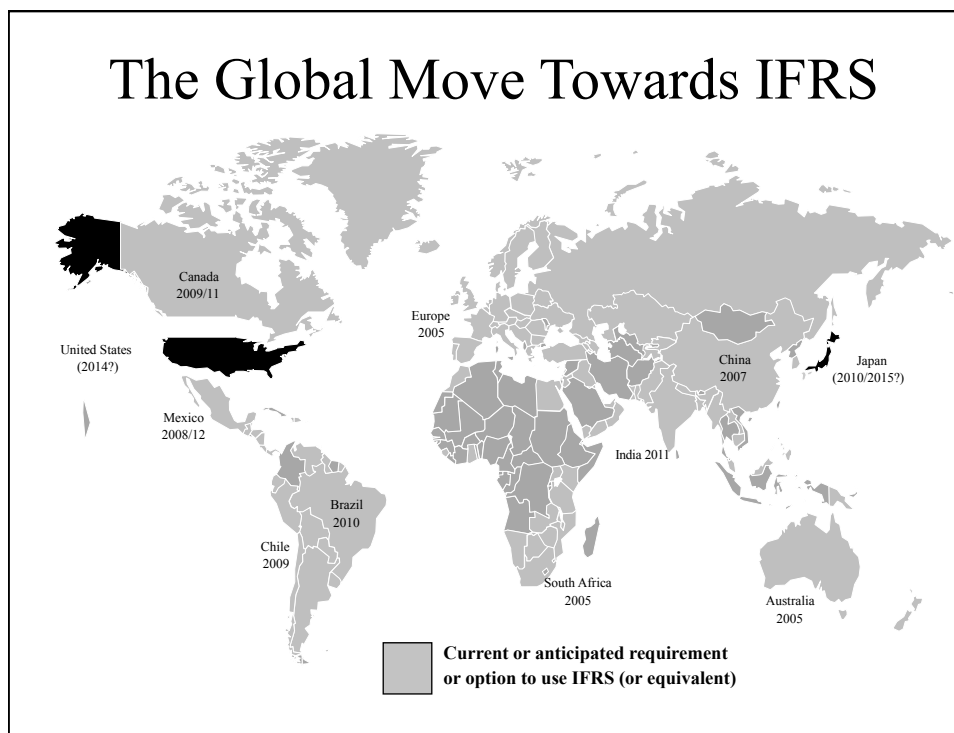
- IAS 39 and its multiple revisions have forced companies to reevaluate systems, processes, documentation, risk management strategies and reporting
- More changes are coming in the form of International Financial Reporting Standards (IFRS)

## International Financial Reporting Standards – IFRS 9

- In November 2009, IFRS 9 became the first phase of replacing IAS 39
- The goal of IFRS 9 is to make it easier for users of financial statements to assess amount, timing, and uncertainty of cash flows
- IFRS 9 provides stronger criteria to address when to apply fair value versus amortized cost measurement to specific financial instruments

## IFRS 9

- The scope of IFRS 9 is limited to financial assets and does not change classification and measurement of financial liabilities
- New standard is effective January 1, 2013



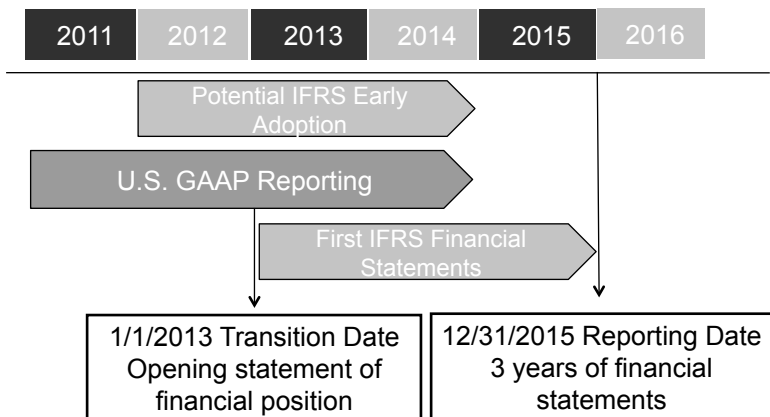
## IFRS 9

- IFRS 9 is an attempt to reduce complexity of IAS 39 in four areas:
  1. Decrease the number of classification and measurement categories
  2. Eliminate complex rule-based requirements
  3. Tainting rules forcing reclassification to fair value of all instruments have been eliminated
  4. Creation of a single impairment method for financial assets not marked at fair value



## Possible timeline for adoption

The SEC anticipates providing four to five years for IFRS adoption



4.2

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## Next steps and expectations

Work Plan + Convergence = SEC decision in 2011

- Final rulemaking necessary in order to implement any mandate
- Will be exposed for public comment
  - Adequate time will be allowed for adoption
    - Any mandate would not be effective until approximately 2015 or 2016
  - Early adoption may be allowed once a mandate is decided
- Future role of the FASB to be determined
- Liaison between IASB and U.S. constituents?
  - Provide technical advice to SEC on endorsement of IFRSs?

4.1

## Industry Survey Results

- Expectations that IFRS 9 will reduce financial measurement and reporting complexity appear mixed
- A recent Certified Financial Analyst (CFA) survey based on feedback from over 640 respondents reached these findings:
  - 47 percent said IFRS 9 would be an improvement
  - 22 percent said IFRS 9 would not be useful
  - 31 percent were neutral



### **Extras from ACC**

We are providing you with an index of all our InfoPAKs, Leading Practices Profiles, QuickCounsels and Top Tens, by substantive areas. We have also indexed for you those resources that are applicable to Canada and Europe.

Click on the link to index above or visit <http://www.acc.com/annualmeetingextras>.

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