

# Accounting for Financial Instruments —The Door is Opening

Number 6

KPMG ENTERPRISE

Canada's private businesses are eagerly awaiting the release by the Accounting Standards Board (AcSB) of its proposals for a new financial reporting framework for private companies. One of the most anticipated aspects of the new model is the accounting model for financial instruments.

Canadian generally accepted accounting principles (GAAP) were substantially based on historic cost until about five years ago. At that time, the AcSB, under its mandate to converge Canadian GAAP with US GAAP, adopted a new suite of standards for financial instruments that transitioned the accounting to a fair value based model and introduced the concept of comprehensive income to Canada. The standards are very complex and rules-driven and proved costly to implement. Private businesses were to have adopted the standards for fiscal years ending on or after September 30, 2008 but the AcSB withdrew that requirement in anticipation of the new private business model.

The challenges of the suite of financial instruments standards have included:

- the determination of the appropriate categorization of financial assets (available for sale, held for trading, held to maturity, loans and receivables)
- the need to identify, segregate and value embedded derivatives
- the requirement to value most financial instruments at fair value – this often involved the use of complex valuation models
- rigorous rules on establishing the effectiveness of hedging relationships along with the requirement to measure and record ineffectiveness, and
- comprehensive and detailed disclosures regarding the risk profile of financial instruments

The AcSB has provided a glimpse at its plans for the new accounting standard for financial instruments held by private businesses. The changes are significant:

- financial instruments, excepting for equity instruments traded in an active market and free-standing (speculative) derivatives, will be measured at amortized historical cost
- investments in the equities of other companies will be marked to fair value but only where there is an easily accessible value from an active market

- the only other use of fair value accounting will be for investments in speculative derivatives and companies will generally be able to use information provided by the bank where the bank is the counterparty
- effective hedging relationships will be recognized through comprehensive note disclosures that will inform the user of the contractual terms of the hedging instrument, without a need to determine fair value and recognize the fair value on the balance sheet
- there will be no requirement to identify and segregate embedded derivatives
- any mark-to-market adjustments will flow straight to income without the need for the concept of comprehensive income

In addition, the new standard will remove the requirement (it will remain an option) to bifurcate compound financial liabilities (financial liabilities that contain an equity option). As such, both the carrying value of the liability on the balance sheet and the interest expense on the income statement will reflect the contractual terms of the debt, rather than an implicit effective interest rate based on the relative fair values of the debt and equity components.

A further and related simplification being proposed is the option to use the straight line method of amortizing premiums, discounts and other charges related to financial instruments, rather than having to use the effective interest method. In addition, the AcSB is working to finalize a common model for testing financial assets for impairment, based on material changes in expectations about the quantum and timing of future cash inflows. The current standards incorporate different tests for accounts receivable, loans and other financial assets, creating unnecessary complexity.

We believe that preparers and users of the financial statements of private businesses will welcome these proposals. Users will still have access to the information they require and preparers will enjoy reduced costs of preparing financial statements.

The AcSB continues to target a March 31, 2009 release of its comprehensive Exposure Draft on the financial reporting framework for Canada's private businesses. We would strongly encourage you to participate in the exposure process by reading the Exposure Draft, considering its relevance to your business and providing feedback to the AcSB. Your KPMG Enterprise professional adviser would also be pleased to receive your input as KPMG will be responding to the Exposure Draft.

We will continue to advocate for accounting standards relevant to Canada's nearly two million private businesses.

If you have any questions or issues you would like to discuss, please contact a member of your KPMG engagement team or one of our IFRS professionals.

## Accounting for Financial Instruments

Challenges under GAAP	Proposed Private Business GAAP Solutions
Categorization of financial instruments amongst available for sale, held for trading, held to maturity and loans and receivables categories	No categorization
Valuation of most financial instruments at fair value sometimes requiring use of complex valuation models	Valuation of investments in equities at fair value when the value is easily available. All other financial instruments are carried at
Identification, segregation, recognition and valuation of embedded derivatives	Only freestanding derivatives are recorded
Complex hedging rules based on fair value	Simplified, but restricted use of hedge accounting supported by note disclosure
Comprehensive note disclosures addressing risk profile of financial instruments	Simplified and reduced disclosures
Mark-to-market adjustments allocated between income and other comprehensive income based on complex rules	Any required mark-to-market adjustments flow directly to income
Convertible debt securities are bifurcated between debt and equity components. Interest expense is based on underlying effective interest rate, not contractual rate	Option to recognize convertible debt instruments as liabilities, without bifurcation, and to record interest expense based on contractual rate
Multiple impairment models	One impairment model with requirement to test annually

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative.  
 © 2009 KPMG LLP, a Canadian limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International, a Swiss cooperative. All rights reserved. Printed in Canada on recycled paper. MW