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**NEW MEASUREMENT STANDARD FOR FINANCIAL ASSETS AND LIABILITIES - CICA
SECTION 3855**

Paul Gibbons
Partner
Deloitte & Touche

Richard Nunn
Partner
Deloitte & Touche

Deloitte.

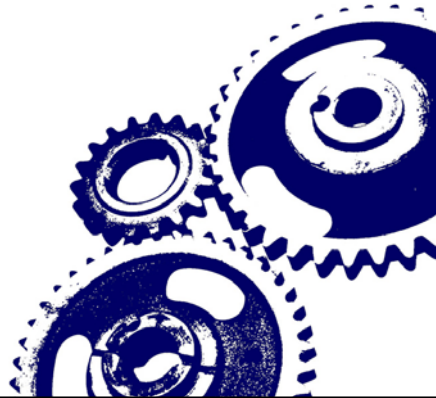
The New Financial Instruments Standards

**Presentation to IDA FAS
Conference**

*Paul Gibbons &
Richard Nunn
Deloitte*

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Audit. Tax. Consulting. Financial Advisory.



Agenda

- Introduction
- Overview of the new Financial Instruments Framework
- Comprehensive Income
- Recognition and Measurement
- Implementation Issues for the Securities industry
- Wrap up

Overview of the new Financial Instruments Framework

Potential Impact

- Impact on financial statements:
 - Creates volatility in the balance sheet, income statement and equity
 - Comprehensive Income – new component in shareholders' equity with its own detailed disclosure requirements
 - Increased gross-up of balance sheet
 - Lack of comparability in transition year to prior year financial statements
 - Will have an impact on the stand-alone GAAP financial statements for Brokers and also may have an impact on the accounting presentation on the JRFQ&R

Key Observations

- Standard requires management to make decisions around classification otherwise default categories apply
- Implementation must be completed before the effective date
 - e.g., evidence of classification at Day 1 i.e. January 1, 2007
- Changes to reporting systems and processes will be required to accommodate the new framework
 - Existing Canadian GAAP reporting process may require significant enhancements to systems and/or processes to support the new reporting requirements

Overview of the new Standards

- New Sections are to be effective for fiscal years beginning on or after October 1, 2006 (i.e. January 1, 2007 for December 31 year end brokers.)
 - CICA 1530, "Comprehensive Income"
 - CICA 3855, "Financial Instruments – Recognition and Measurement"
 - CICA 3865, "Hedges"
 - Many related amendments to existing sections for consistency with new framework (e.g. CICA 1650, CICA 3860)
- Objective is to harmonize (to extent possible) with US GAAP and International Financial Reporting Standards (IAS 39)
 - Warning: Standards are not identical to US GAAP or IAS 39 and differences may result
- Continues the movement towards fair value with more assets and liabilities at fair value
- Expanded definition of a derivative and introduction of the concept of an embedded derivative

Other Comprehensive Income

Section 1530

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CICA Section 1530 Comprehensive Income

- Comprehensive Income is *the change in net assets from all non-owner sources during a period*. It is broader than Net Income as it includes both:
 - Net Income; and
 - Other Comprehensive Income
- Other Comprehensive Income (OCI) is a temporary location for certain gains and losses that are not reported in Net Income. Most common examples include
 - Cash flow hedge and net investment hedge changes in fair value
 - **Self-sustaining foreign entity translation amounts**
 - Available for sale financial assets changes in fair value
- Most brokers will not have the first or third items but may have the second item

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Sample Statement of Comprehensive Income

Statement of Comprehensive Income			20X2	20X1
Net income (per the income statement)			\$ 651	\$ 22
Other comprehensive income (net of tax)				
	Unrealized foreign currency gains and losses on translating self-sustaining foreign operations		\$ 547	\$ 627
	Gains and losses on hedges of unrealized foreign currency translation gains and losses (net of tax of \$x)		(545)	(618)
	Unrealized foreign currency gains and losses, net of hedging activities		2	9
	Unrealized gains and losses on available for sale financial assets (net of tax of \$x)		1,689	277
	Reclassification adjustment for gains and losses included in income (net of tax of \$x)		(317)	62
	Change in unrealized gains and losses on available for sale financial assets		1,372	339
Other comprehensive income			\$ 1,374	\$ 348
Comprehensive income			\$ 2,025	\$ 370

Financial Instruments – Recognition and Measurement

Section 3855

Classification of Financial Instruments

- All financial instruments must be classified into categories
 - The classifications determine the ongoing measurement basis
- All financial assets subject to S3855 are classified as:
 - **Trading**
 - **Available-for-sale**
 - **Held-to-maturity**; or
 - **Loans and receivables**:
- All financial liabilities subject to S3855 are classified as:
 - **Trading**; or
 - **Other financial liabilities**

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Classification Summary

	Categories	Initial Measurement	Subsequent Measurement	Gains and losses
Assets	Loans and receivables	Fair value	Amortized cost using the effective interest method	Recognized in P&L during the period asset is derecognized or impaired (both FX and impairment recognized immediately in P&L)
	Held-to-maturity investments			
	Available-for-sale financial assets	Fair value	Fair value*	Recognized in OCI (impairment recognized in P&L immediately)
	Held for trading	Fair value	Fair value	Recognized in P&L for the period
Liabilities	Held for trading	Fair value	Fair value	Recognized in P&L for the period
	Other	Fair value	Amortized cost using the effective interest	Recognized in P&L during the period liability is derecognized

*Equity instruments that do not have a quoted market price in an active market are measured at cost even if considered available-for-sale

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How to Determine Classification

- **Classification is determined by one of the following:**
 - **Characteristics**
 - Some types of financial instruments are defined in terms of their characteristics (e.g. derivatives)
 - **Intent and ability**
 - Held-to-maturity requires intention and ability to hold to maturity date
 - Held for trading may, but need not, be based on intent to sell for a profit in the near term
 - **Choice**
 - Upon initial recognition, an entity may elect to irrevocably designate any financial asset or liability as held for trading
 - An entity may also elect to designate any non-derivative financial asset as available-for-sale
- **Classification should be documented with evidence on Day 1**

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Effective Interest Method

- Entity A purchases a debt instrument with five years remaining to maturity for its fair value of \$2,700.
- The instrument has a principal amount of \$3,000 and carries a fixed interest rate of 5% per year which is paid annually.
- The following illustrates the yield under an effective interest method as compared to the yield using a straight line approach.

Year	Accreted Principal	Accretion/ Accrued interest	Yield	Effective Yield Interest Income	Yield
	2,700				
20X1	2,760	(60+150) 210	7.61%	200	7.30%
20X2	2,820	210	7.45%	206	7.30%
20X3	2,880	210	7.29%	210	7.30%
20X4	2,940	210	7.14%	215	7.30%
20X5	3,000	210	7.00%	219	7.30%

Yield is constant while interest income varies

Simplified for example purposes

Interest income is constant while yield varies

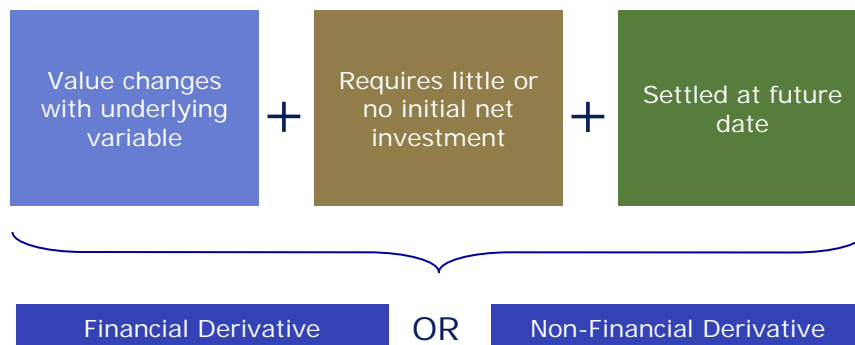
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Expanded Definition of a Derivative

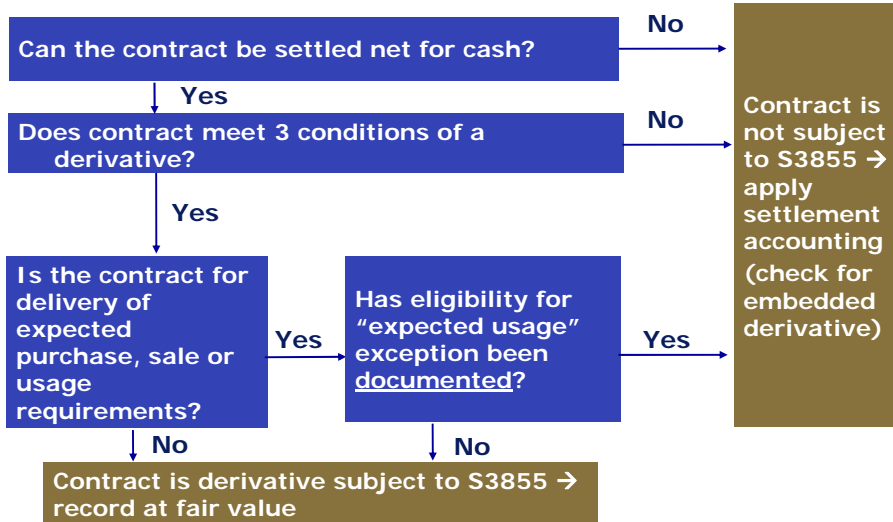
Definition of a Derivative

- A **derivative** is a financial instrument or other contract with three characteristics



Decision Tree for Non-Financial contract

Is the contract within the scope of S3855?



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Contracts to Buy Non-Financial Items - Example

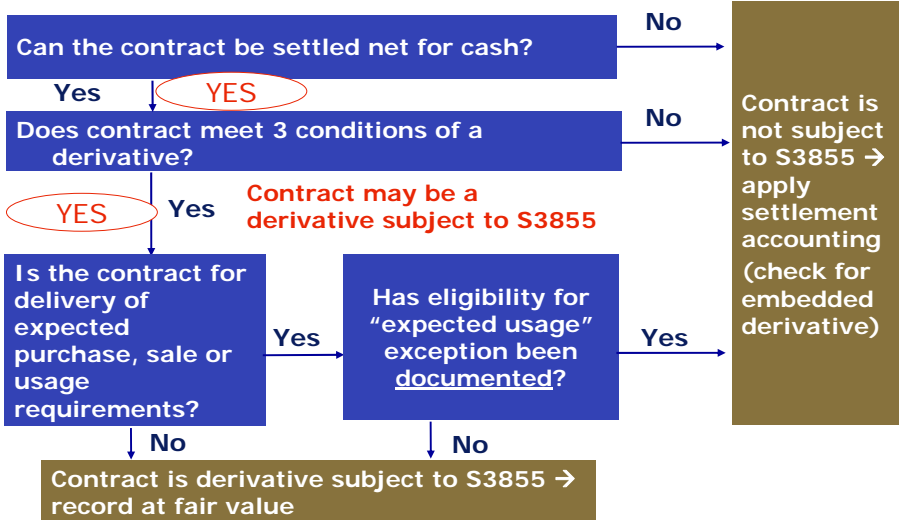
- A company enters into an agreement to purchase natural gas for fixed price in three months time from a supplier to use to operate its building facilities.
- Analyze this contract to determine if it meets the definition of derivative under S3855

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Non-Financial Contract Example – Solution

Is the contract within the scope of S3855?



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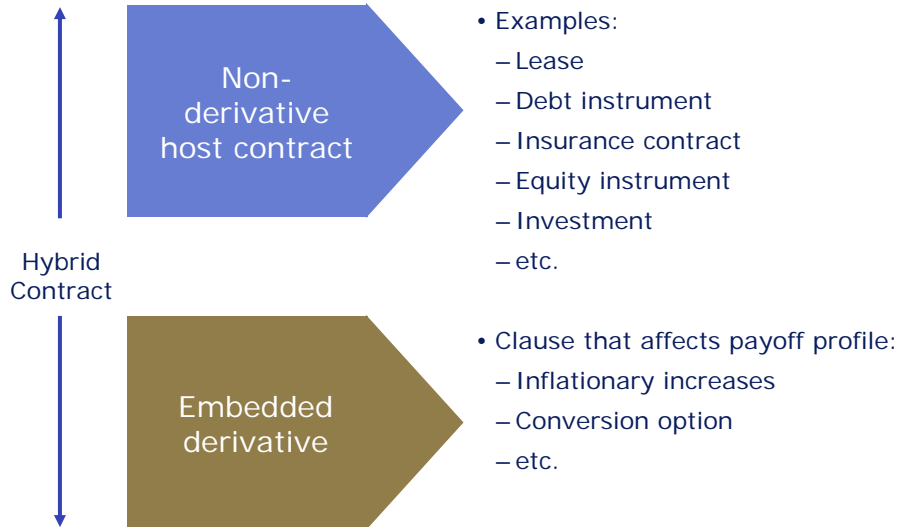
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Embedded Derivatives

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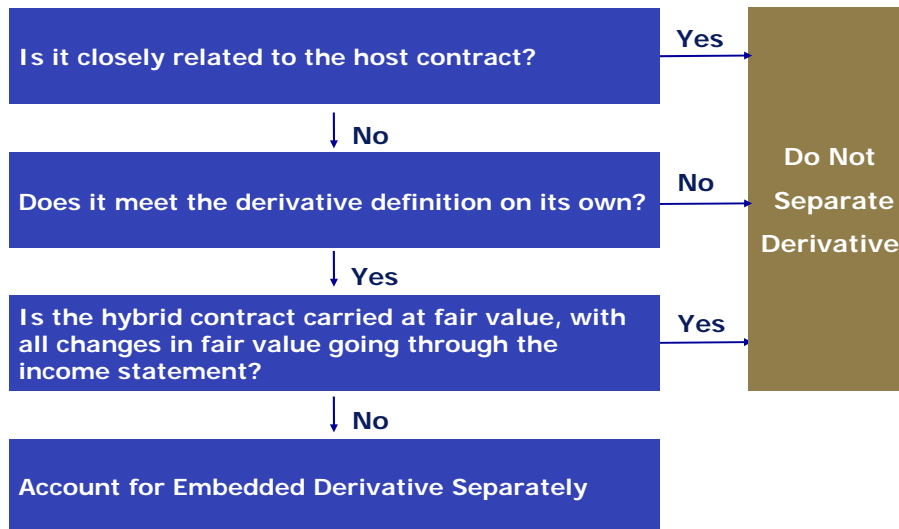
Embedded Derivatives



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Embedded Derivatives – Decision Tree



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Lease Host

- **Closely related**

- Non-leveraged inflation (payments increase with CPI)
- Contingent rentals based on sales
- Foreign currency payments in the functional currency of a substantial party to the lease

- **Not closely related**

- Leveraged inflation (payments increase by 5 times CPI)
- Inflation in different economic environment
- Foreign currency payments that are not in the functional currency of a substantial party to the lease

Determining Fair Value for Financial Instruments

Determining Fair Value

- Two tier approach
 1. Quoted market prices in an active market
 2. Valuation techniques (if no active market exists)
- Valuation techniques
 - Recent arm's length market transactions between third parties
 - Fair value of instrument that is substantially the same
 - Discounted cash flow analysis
 - Option pricing models
- Use most common technique used by market participants

Certain Fair Value Issues

- Quoted prices

Current bid price is to be used for an asset held and the asking price for an asset to be acquired (although using mid-market prices is permissible for establishing fair values of offsetting risk positions, and then apply the bid or asking price to the net open position)
- Valuation techniques

Fair value is to be estimated based on the results of a valuation technique that makes maximum use of inputs observed from markets, and relies as little as possible on inputs generated by the entity
- Embedded derivatives

If an entity is unable to measure the fair value of an embedded derivative in a financial instrument separately, it treats the entire combined contract as a financial asset or liability that is held for trading

Implementation Issues

Financial Instruments – Implementation Issues for the Securities Industry

- Inventorying and classifying all S3855 financial instruments
 - Document at Day 1 effective date and/or origination date
- Working with service providers to ensure systems changes for pricing feeds, interest method calculations etc
- Accounting for transaction costs (need to separately present as an operating expense on the income statement)
- Separate presentation of OCI on Statement F or in the standalone financial statements and reclassifying out of AOCI
- Inventorying embedded derivatives
 - Recognize embedded derivatives arising from contracts entered into no later than the start of the fiscal year ending on March 31, 2004 or earlier (say consider aligning with US GAAP effective date)
- Implementation of effective yield method to measure amortized cost of assets or liabilities
 - Straight line amortization for debt securities, loans and receivables no longer permitted
 - May have an impact on geography on the income statement or Statement E
- Identification of new derivatives
- Opening adjustments to retained earnings and AOCI

Summary of the new Financial Instruments Framework

- The new framework may have a pervasive impact on the financial statements
- Impact on financial statements may include:
 - Increased gross-up of balance sheet (embedded derivatives)
 - New Statement of Comprehensive Income
- Implementation must be completed before the effective date
- Changes to reporting systems and processes may be required to accommodate the new framework

Wrap up:
Any final questions?



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