

Accounting for Financial Instruments

Document intended for students preparing for a professional examination¹

(this English version has been translated from French by Karen McFaul)

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¹This document can be useful to students preparing to write the uniform final examination (UFE), leading to the Chartered Accountant designation. It can be used as a complementary reference for students preparing to write the entrance examination leading to the Certified Management Accountant designation or the financial accounting FA-4 leading to the CGA designation. It can also be used in other training sessions addressing issues related to financial instruments or evolution of accounting standards (notably accounting theory).

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Preamble – Teaching note

This document is published as a pedagogical tool as defined in section 5.3 of the document « Comité de la recherche du département de sciences comptables de l'Université du Québec à Hull ». It is about a subject very much in the news: accounting for financial instruments. It deals with the very current issue of accounting for financial instruments. This issue is the object of many discussions because the standards presently in use lead to disparate accounting treatments that are often disconnected from the economic reality. The present accounting standards are, evidently, being re-evaluated. The Accounting Standards Committee has actually been looking into the financial instruments problem for many years. After two exposure-drafts (1991 and 1994), presentation has been the object of the CICA new standard 3860. However, measure is still at the centre of controversy.

The present document is enrolled in the progressive context of accounting standardisation of financial instruments. It is addressed to professors and students involved in courses with the goal of exposing the economic reason of financial instruments and the view of defining the key accounting issues and choices. The specific objectives, indicated in page 3 of this document, are about the economic aspects of financial instruments as well as actual accounting standards and the ones being studied. It distinguishes itself from what is presently known and available for these reasons:

- It integrates the economic and accounting aspects related to financial instruments;
- It does not wish to give final solutions to problems, but rather to bring the students to use their ability to make deductions based on the economic reality of financial instruments and the present context of the accounting framework;
- It popularizes the terminology to help the student understand the key issues and arguments supporting the alternative accounting treatments;
- It is relatively concise if we consider the spread and complexity of the subject;
- It provides practical suggestions to the student for his preparation towards an examination on financial instruments.

This document can be useful for many types of educational purposes. It can be used as a reference in a course lasting a couple of days on accounting for financial instruments. In that respect, it can constitute an obligatory reference for courses preparing students with the goal of writing the uniform final examination leading to the Chartered Accountant designation. It can also be used as a complementary reference for students preparing to write the entrance examination leading to the Certified Management Accountant designation or the financial accounting FA-4 leading to the CGA designation. Finally, it can be of assistance for other educational activities talking about accounting for financial instruments or the evolution of accounting standards (in particular accounting theory).

It is suggested to students to read this document and to prepare their questions before the classes. On an educational standpoint, the teacher can give the course as a lecture, whilst answering student's questions. It is also suggested to give practical application examples from real financial statements^a. It is also desirable to demonstrate certain technical aspects with the help of examples like the ones presented in the appendix of the April 1994 exposure-draft on financial instruments^b.

The author wishes to thank the teachers and students having put forward some comments and suggestions about the content and the form of the present document.

^a See section titled "What financial statements are susceptible of containing information needed by users" on page 12 of the present document.

^b Other examples are available in CICA Handbook [section 3860 appendix], Laroche and St-Cyr [1996]; Blanchette [1989] and OCDE [1988].

INTRODUCTION

As we are getting ready to enter the new millennium, we are witnessing a mutation in the business world: international exchanges are multiplying; commercial barriers are falling; free trade agreements are signed; communist countries are getting closer to a market economy; hence, competition is measured on global scale. In this wave of globalization, financial instruments have been growing at an incredible pace. Moreover, derivatives, such as swaps, have literally taken over financial markets. This has made it easier to manage currency exchange risk and interest rate risk.

The objective of financial statements is to communicate information that is useful to users in making their resource allocation decisions and/or assessing management stewardship. [CICA Handbook, 1000.15]. However, the actual accounting disclosure of operations involving new financial instruments is questionable since it is not adapted to reality. This is even more true with the fact that financial instruments are considered off balance sheet. It is the author's view that accounting for financial instruments constitutes the main challenge, both Canadian and international, standard-setters must overcome². Financial problems and bankruptcies of organisations which seemed to be financially healthy is certainly contributing to this situation³.

The main references about accounting for financial instruments in Canada are the CICA Handbook, standard 3860 and the exposure-draft published in April 1994 by the Accounting Standards Committee (here after the Exposure-Draft [E-D])⁴. The present document covers the main standards (including Emerging Issues (EIC) and accounting guidelines) and the exposure draft related to financial instruments presently applicable in Canada. Its goal is to explain the accounting concepts and standards proposed. The specific objectives are:

I- Recognizing financial instruments.

II- Understanding the rewards, costs and risks that they entail.

III- Knowing the information needs towards them.

IV- Being able to analyse and critique appropriate accounting alternatives, with the framework of the present standards and keeping in perspective their evolution.

V- Being ready to react with effectiveness during an exam!

Sections I and II deal with the economic aspects of financial instruments. Section II bridges the gap between the financial aspects and the accounting standards presented in section IV. Suggestions and discussion elements are proposed in certain places throughout the text (*in italic*) and in section V, to help students preparing to pass an examination.

²Long-term corporate investments and foreign currency translation represent also some key challenges faced by standard-setters in the present context of globalization.

³An example is the case of Barings in Britain.

⁴In this document all citations refer to the CICA Handbook unless otherwise indicated. Also, see Laroche and St-Cyr [1996] who proposes an explanation of basic notions of derivative financial instruments to make the risks evident to a professional in accounting. Note, as well as applying to financial instruments, certain guidelines discussed in this document could be applied to non financial instruments such as merchandise contracts [see 3060.A17 and footnote #1 of E-D.014].

These definitions are important because they specify what we intend by “financial instrument” from an accounting point of view. It paves the way to fundamental accounting questions, such as recognition, presentation and measure:

- C Recognition is including (or not) an element in the balance sheet. It is even more important because of the fact that many financial instruments are considered off balance sheet. These come from past contracts, for which no cash flow has been recorded or paid in the beginning, but that are susceptible of generating future gains or losses.
- C Presentation involves an understanding of the types of elements to include in the financial statements (assets, liabilities or equity in the balance sheet; revenues or expenses in the income statement; equity operations - like dividends in the statement of retained earnings, and the issuance of shares) and deciding whether to compensate or aggregate certain elements (like a forward contract and an underlying asset; a swap and an underlying debt; a fund designated to the reimbursement of a debt and the debt in question⁵).
- C Accounting measurement is normally at the historical value, except in certain circumstances where the fair value is used.

Here are a few examples of financial instruments consistent with definitions of standard 3860:

Cash,
Accounts receivable, accounts payable,
Interest bearing investments,
Stock investments⁶,
Loans payable, loans receivable,
Interest payable, interest receivable,
Bonds,
Convertible securities,
Liability recorded following a capital lease contract, amounts receivable following a sales-type lease or a direct financing lease contract,
Call and put options, that when exercised, entail an exchange of financial assets,
Swaps,
Guaranteed rates (caps, floors, collars)
Credit commitment, deposit,
Preferred capital stock redeemable at the holders convenience (liability)
Dividends receivable, dividends payable,
Portion of a financial asset/liability of instruments attached to the value of merchandise⁷

Here are examples of shareholder’s equity instruments:

Common stock, preferred stock,
Right and obligation to issue shares (stock warrants)

⁵Commonly called “in-substance defeasance”.

⁶Investment in a subsidiary company, an entity subject to significant influence or a joint venture are not covered by standard 3860, as well as employee remuneration packages leading to the issuance of shares [3860.03]. However, EIC-75 specifies when to apply paragraph 3860.03 regarding non-consolidated investments in a subsidiary or a joint venture as well as an entity subject to significant influence.

⁷Normally instruments involving the delivery of merchandises are excluded from the definition of financial instruments. Instruments conveying the right to the holder to choose money or other financial assets or a determined quantity of merchandise are in conformity with part of the definition of a financial instrument; they entail a financial asset (a claim) and a non financial asset (the option to exchange the claim against a determined quantity of merchandise). [3860.A16 and E-D:015,A.87]

Are excluded from the definition of a financial instrument in standard 3860:

Inventory, prepaid expenses, capital assets,
Deferred revenues, estimated liability under warranties,
Contracts for the purchase/sale of tangible assets or the receipt/benefit of services,
Taxes,
Minority interests.

The important thing during an exam is not to memorize all the criteria to identify a financial instrument, but to recognize operations susceptible of producing financial instruments or similar. What is the usefulness of knowing all the technical details if one doesn't think about using them when an opportunity occurs? It is important to understand that there are a multitude of financial instruments and their presence in an examination will not be referred to as such. It is better to have a good comprehension of the basic principles in order to be able to adapt them to the situation at hand and enrich the discussion rather than having memorized a large quantity of information that can't be integrated intelligently in a response (commonly known as dumping).

To help in the understanding of standard 3860 definitions, a table illustrating the classification as financial instruments (or non) of certain operations, is presented in the following pages.

TABLE ILLUSTRATING THE CLASSIFICATION AS FINANCIAL INSTRUMENTS (OR NON) OF CERTAIN OPERATIONS

Operations	Entries in one entity	Entries in the other entity	Financial assets	Financial liabilities	Equity components	Excluded from the definition of financial instrument or not applicable to standard 3860
Sales	Accounts receivable	X	Accounts receivable	Accounts payable		Inventory
	Sales Cost of goods sold Inventory	X X X X	Purchases or Inventory Accounts payable			
Borrowing	Cash	X	Cash	Loan payable		
	Loan payable Interest expense Interest payable	X X X X	Loan receivable Cash Interest receivable Interest income	Interest payable		
Endorsement	Expense (or Receivable item) Endorsement payable (in the endorser's books of account)	X X	Receivable item Loan receivable	Payable item Loan payable		
	Loan payable Gain (or Payable item) (in the endorsee's books of account)	X X	Receivable item (in the banker's books of account)			
Convertible bonds	Bond investment Investment - CV	X X	Cash Bond investment	Bond payable	Surplus - CV	
	Cash (CV = conversion value)	X	Investment - CV			
Financial asset options	Investment Cash or Payable	X X	Cash Receivable Investment	Payable Debt		
	Investment Cash or Payable	X X	Cash Receivable Investment	Payable	Surplus	
Merchandise options	Investment Cash or Payable	X X	Cash Receivable	Payable		Investment Goods to deliver
	Investment Cash or Payable	X X	Cash Receivable Investment	Payable Debt		
Financial asset forward contract	Investment Cash or Payable	X X	Cash Receivable Investment	Payable Debt		
	Investment Cash or Payable	X X	Cash Receivable	Payable		
Merchandise forward contract	Investment Cash or Payable	X X	Cash Receivable	Payable		Investment Goods to deliver
	Investment Cash or Payable	X X	Cash Receivable Investment	Payable Debt		

Operations	Entries in one entity	Entries in the other entity	Financial assets	Financial liabilities	Equity components	Excluded from the definition of financial instrument or not applicable to standard 3860
Common stock	Portfolio investment	X	Cash		Common stock	Investment subject to significant influence Investment in a subsidiary Investment in a joint venture
	Cash	X	Portfolio investment			
	Investment subject to significant influence	X				
	Cash	X				
	Investment in a subsidiary	X				
Preferred stock	Cash	X				
	Investment	X	Cash		Preferred stock	
Preferred, redeemable stock on a set date	Cash	X	Cash	Preferred stock		
Cash dividend	Cash or Dividend receivable	X	Cash	Dividend payable		
Interest rate swap	Dividend revenue	X	Dividend receivable			
	Interest receivable	X	Interest receivable	Interest payable		
	Interest expense	X	Interest receivable			
Currency swap	Interest payable	X				
	Interest income	X				
	Interest receivable	X	Receivable	Payable		
	Interest expense	X				
Prepaid expenses	Prepaid expenses	X	Cash			Prepaid expenses
	Cash	X				Deferred revenues
Fixed asset disposal	Fixed asset	X	Cash			Fixed asset
	Cash	X				
Income tax	Tax expense	X				Income tax payable
	Income tax payable	X				Deferred tax

OBJECTIVE II - REWARDS, COSTS AND RISKS

Why do entities incur financial instruments?

Answer: To make money! Or prevent losing some!

To make money

Financial instruments can be traded with the goal of directly making a profit. That's generally the case with stocks, bonds and other investments susceptible of generating dividends, interests or capital gains. These operations are often qualified as 'speculative'.

Financial instruments can also be traded in order to ease other transactions with the goal of making profits. The financial instrument, in this case, is an intermediary step leading to something else. That is also the case when cash obtained from a loan is reinvested in a project, or when an endorsement is granted in exchange for past, present or future services/revenues.

Financial instruments can be the result of normal transactions from which they are created. For example, accounts receivable and accounts payable resulting from sales and purchases.

Finally, financial instruments can be traded with the idea in mind of making money from the market's imperfections. Such a strategy is called 'arbitrage'. Examples include financial arbitrage with an interest rate swap allowing to obtain a lower 'net' interest rate than what would normally be granted; tax arbitrage allowing an entity to transfer revenues from a country which is highly taxed to a country who is not⁸. It should be noted that as markets are getting more competitive on a global scale, these strategies are becoming the object of increased surveillance and regulation. As well, apparent economies from arbitrage are sometimes compensated by less apparent risks like credit risk and risk related to the formulation of the contract.

To prevent losing money

Financial instruments can also be traded to limit the risks of incurring losses. In that case, the entity is looking to reduce the sensitivity of certain positions to non anticipated market variations, including interest rates and exchange rates. These financial instruments are used to create compensatory positions having for effect the cancellation or reduction of unfavourable consequences created by market variations. For example: a forward contract that transforms in local currency future funds that would otherwise be received in foreign currency reduces the risk of incurring a loss consequent to an unfavourable variation in exchange rates; an interest rate swap having the effect of reducing the exposure of an entity to variations in interest rates for certain maturity dates reduces the risk of incurring a loss due to an unfavourable variation in interest rates; a put option for a financial security at a fixed price reduces the risk of incurring a loss if we hold the same security as an asset and if its value falls on the market.

Matching positions

It is important to know that financial instruments are often traded to accompany existing positions and therefore modify their substance. Financial instruments are then matched to an underlying identified position, even though they remain separate for legal purposes. This matching notion is practically always present in hedging strategies, without, however, being limited to this type of strategy. For example, we can easily modify, with the help of a swap, the substance of a loan, either for hedging or speculation. The idea is not necessarily to reduce exposure to risks, but to modify it according to our

⁸For more examples and explanations, see Blanchette [1989, pp. 34-41].

objectives and anticipations⁹.

What are the costs and risks associated with financial instruments?

Answer: Obviously, nothing's free. To appreciate the fair value of a financial instrument's rewards, we must ponder them versus the risks and costs associated.

Costs

The operation and transaction costs associated with financial instruments are easy to identify when they are monetary exchanges. It is the case, for example, of commissions paid to a broker and interests paid on a loan. However, there is a multitude of ways to modify the nature of certain fees. This can lead to believe that they have been reduced when in fact they simply have been transferred. An example of this is a loan for which, on one hand, we would have reduced the fees due at the time of signature, and on the other, increased the contractual interest rate (in comparison with market rates). Inversely, increasing certain fees related to a loan with a reduction in interest rates could lead to believe that the rate is abnormally low in comparison with the market. Other examples are zero-coupon bonds and treasury bonds who in substance imply interests, but contain no interest rate in the contract.

We must not be misguided by appearances and come to conclusions too quickly when dealing with fees related to financial instruments. We must look at the contract as a whole in order to identify the costs and risks contained, keeping in mind that certain elements can sometimes be hidden or moved.

Risks

Along with the costs corresponding to sums of money directly described in the contract, we must also take into consideration the underlying risks associated with financial instruments. This notion of risk makes reference to uncertainty inherent to future cash flows, which can translate into a distribution of probabilities of certain events occurring. Standard 3860.44 presents four types of risk: price risk, credit risk, liquidity risk and cash flow risk.

- a) Price risk, the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates, interest rates or the prices of the underlying security.
- b) Credit risk, the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.
- c) Liquidity risk, also referred to as funding risk, is the risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments.
- d) Cash flow risk, the risk that future cash flows associated with a monetary financial instrument will fluctuate in amount.

It is important to be able to recognize these four types of risk and to be able to apply them to the particular situation of financial instruments. For example, securities bearing a fixed interest rate hold an interest rate risk and possibly other risks such as credit and liquidity, but no cash flow risk. With such securities, the amounts of future cash flows are known in advance due to the fixed rate of the contract. On the other hand, their fair value varies according to the evolution of interest rate market because an investment at a fixed rate increases in value when the market goes down (and vice versa), even though the fixed cash flows are known with certainty a priori.

Moreover, securities bearing a variable or floating rate hold a cash flow risk but normally no price risk. As a matter of fact, the fair value of the security does not depend on the evolution of interest rates as the contractual rate is automatically adjusted to the market rate. However, variations in interest cash flows are susceptible of being important.

Many forward contracts and options do not contain, like fixed interest rate bearing securities, any cash flow risk since we know in advance the exercise price. However, they are subject to a price risk, depending on the volatility of the market value of the underlying elements.

⁹Matching examples will be demonstrated in class (see Blanchette [1989, appendix D and E]).

In addition to the four types of risk mentioned in standard 3860, some other risk aspects may apply to financial instruments [Blanchette, 1991]. The Risk of the formulation of the contract is the risk that the legal form used does not accurately reflect the economic substance of the contract originally desired. It applies to financial instruments who are minimally regulated, like swaps. Also, an important component of credit risk is often related to as country risk. It is the risk that the other party will default on one of its obligations, following a political or economic situation occurring in the country where it is located.

Measuring risk

We can analyse risks under two angles: an individual or global view. Individual analysis consists of considering only one particular security in relation to the underlying uncertainty inherent in its contractual characteristics. This approach is pertinent in certain cases where the securities are held for speculative reasons. However, a more global approach, incorporating all the elements recognized in the balance sheet and the ones considered off balance sheet, is necessary to evaluate the real risks assumed by the entity. For example, an asset holding by itself a high risk (like a portfolio investment in a company having a high risk) may have no effect on the global risk of the entity if the entity holds a put option of a similar quantity of the same asset at a price fixed in advance. The idea is to aggregate all the risk factors in order to obtain the net exposure of an entity to incur losses following future events.

For the risk concerning interest rates, we measure an entity's exposure by calculating the net balance of asset elements minus the term liabilities bearing for each of the contractual repricing or maturity dates. To do so, we classify securities bearing interests into sub groups according to their term date or rate revision date. It is important to include balance sheet securities as well as off balance items. Certain securities have many elements, like loans repayable in portions (an element for each portion payable) and swaps (an asset element and a liability element). And, each sub group should be considered like a different portfolio for which the net balance constitutes the entity's real exposure to interest rate risk.

The exposure to foreign exchange risk is measured in the same way, with sub groups established according to the foreign currency and term dates or conversion into local currency. We can also combine the analysis of exposure to interest rate risks and exchange risks. Financial institutions often provide this information in their annual reports¹⁰.

For credit risk, we can either analyse an entity's exposure by calculating the maximum amount it stands to lose assuming all the debtors default on their engagements, and by evaluating the default probabilities. This analysis can be done as a whole or by sub groups according to the common characteristics of the debtors and term dates.

Liquidity risk depends on the entity's capacity of generating future funds. Prospective information is needed to do this. It should take into account all the future cash flows with their realization probabilities, coming from the balance sheet and off balance sheet items, as well as the entity's future operations (on all levels including operations, financing and investments).¹¹

Cash flow risk, particularly cash flows associated with a fluctuating instrument, can be valued by calculating the fair value of the financial instruments on a given date, accompanied with potential variations in market value and corresponding probabilities.

¹⁰For example, the Royal Bank published, in its 1996 annual report, a table analysing the sensitivity to interest rates incorporating off balance sheet and foreign currency items [see the following internet address: www.royalbank.com/english/fin/].

¹¹It is understood that this question is essentially on a management level as well as for analysis by external users. However, it is the author's opinion that the purpose of financial statements is not to reveal future anticipations but rather to show the financial situation at a particular date in time and the past performance of the entity in the most possible reliable way. The rest is the responsibility of managers, investors and other external users who need more information than that contained in the financial statements.

OBJECTIVE III - INFORMATION NEEDS OF USERS

Accounting plays the role of an information system at the service of users. In Canada, the CICA Handbook specifies that the main users are investors and creditors [1000.11]. In the present section, the elements relative to financial instruments who preoccupy users are discussed. This is important because user needs influence greatly accounting practices.

What are the information needs of users regarding financial instruments?

Users are interested in operations for which the amounts are important and they want to know their impact on the financial situation and the profitability, present and future, of the entity. For the accounting information to be useful, it must be reliable, relevant, understandable and presented on a timely basis.

- C To determine if the amounts are important, one can compare the market value, or the fair value, with the total assets of the entity; or, the predicted or possible annual cash flows with income; etc... Moreover, we must not forget that the notion of materiality relies on the possibility that the information can influence the decisions of users. For example, if a loan contract of an entity contains a restrictive clause calculated from the debt/equity ratio, then the possible recognition of a financial instrument in the balance sheet is a question susceptible of being very important. Especially in a case where the entity has troubles abiding to this clause.
- C For the information provided in financial statements to be useful, it must be capable of being understood by users.
- C For information to be useful for decision making, it must be received by the decision maker before it loses its capacity to influence decisions. The usefulness of information for decision making declines as time goes by.
- C Information is reliable when it is in agreement with the actual underlying transactions and events, the agreement is capable of independent verification and the information is reasonably free from error and bias. It is relevant when it helps users make decisions.

In reference to financial instruments, users need to know the contractual details permitting to value the amount and volatility of cash flows. In that respect, information should reflect substance as well as reveal the elements needed to value risk. This is even more important for off balance sheet items for which the present value is low but future cash flows are prone to being important. That is the case for swaps and endorsements who include no monetary exchanges (excluding transaction costs) at the signing of the contract, but can hold a high level of credit risk.

What financial statements are susceptible of containing information needed by users?

Every financial statement gives pertinent elements of information. However, the various needs of users bring them to prefer certain information elements rather than others.

- C To value the performance of officers, stockholders are interested in the income statement. This statement holds the many revenue and expense elements relative to financial instruments, including interests, gains and losses (materialized or not).
- C Investors want to know what is the cash flow situation, which is reflected in the cash flow statement. This is the most neutral statement in the sense that it is not subject to arbitrary accounting manipulations as it is in the income statement.
- C To analyse the impact of financial instruments on the financial situation of the entity, users are interested in the balance sheet. Particularly, investors want to know book values and market values, and they want to know what

has been used as collateral. Users are also interested in knowing par values and market values of engagements, as well as the credit risk assumed by the entity. This last item is only partially visible in the balance sheet. To value accounting returns at their fair value, one must weigh them against the risks assumed. Financial statements are certainly useful in that respect, but the notes to financial statements complete the information needed by users. That's the reason why notes are considered as an integral part of the financial statements. The main notes susceptible of containing relevant information about financial instruments are as follows: Disclosure of accounting policies [1505]; Long term debt [3210]; Share capital [3240]; Contractual obligations [3280]; Contingencies [3290]; and other in response to disclosure and presentation requirements for financial instruments [3860].

OBJECTIVE IV - ACCOUNTING TREATMENTS

This section presents the contextual elements needed to value the present situation of accounting standards towards financial instruments. Then, five important questions are identified and discussed in further details in the following pages.

Context

The accounting definition of a financial instrument is very large [3860.05]. It encompasses a wide variety of operations who are the object, amongst others, of specific guidelines in the CICA Handbook (for example 3010, 3025, 3050 and 3065). Likewise, it is highly probable that even more extravagant financial instruments (third generation) will be created in the future and will be added the existing list. In that context, the evolution and trends of accounting standard setting are more important than the standards themselves at a given date. The study of accounting for financial instruments should be included in a research framework answering to the needs, present and future, of users of entities trading financial instruments.

Many standards of the CICA Handbook contain recommendations susceptible of influencing the accounting treatment and disclosure of operations related to financial instruments.

C Standard 3860 prescribes presentation and disclosure policies for financial instruments.

C Standard 1000 defines the conceptual framework on which lies the formulation and application of Canadian accounting principles. Among the most important is the principle of substance over form. Financial instruments can have a multitude of forms, particularly derivatives. They can hold many contractual clauses of which some are based on the value of underlying assets or index. In certain cases, the complexity can be important, like in the case of securitisation. The actual substance of financial instruments can be different than their legal appearance. For example, certain preferred shares resemble more a debt than a share, certain positions appear to be speculative but fill the role of hedging.

Other principles are taken into consideration during the establishment of accounting standards. There is historical cost and conservatism. The historical cost principle does not usually allow to modify the value of an element in the balance sheet. Conservatism, however, occasionally allows to derogate from the historical cost by presenting conservative values (recognition of asset loss in value). We must keep in mind the notion of materiality which is an arbitrary appreciation of the importance of an element for users of financial instruments.

C Standards 3010 and 3050 are about investments. They are resumed by the accounting at historical cost, however when the market value of temporary investments has declined below the carrying value, they should be carried at market value [3010.06] and when there has been a permanent loss in value of a long term investment that is other than a temporary decline, the investment should be written down to recognize the loss [3050.20].

C Standards 3280, 3290 and 3840 deal with contractual obligations, contingencies and related party transactions.

C Finally, many standards touch in a general way financial instruments (1520, 3000, etc.).

Accounting for financial instruments is presently the subject of lively discussions. The accounting standards presently in use are not adapted to the new reality because their application leads to despairing accounting treatments and are often not in touch with the economic reality. The present accounting standards are evidently being questioned. The accounting standards committee has actually been debating the problem of financial instruments for many years. After two exposure-drafts (1991 and 1994), the question of presentation has made the object of standard 3860. However, the question of measure is still the centre of controversy¹².

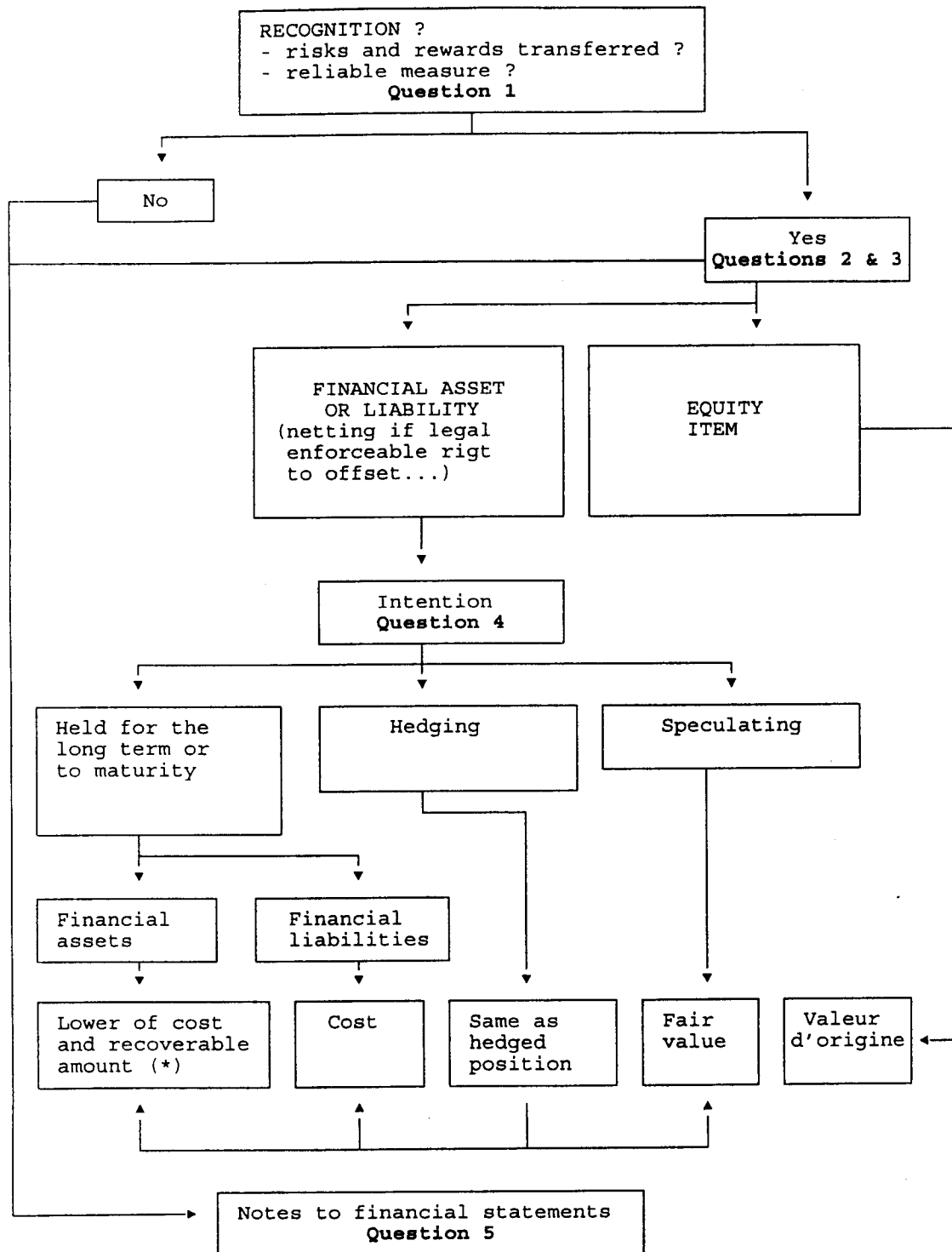
The present section on accounting treatments for financial instruments deals with three important issues: recognition, measure and presentation. It is based on what is proposed in the 1994 exposure draft, which is confronted with the actual state of standards in use. Consequently we will refer to the exposure-draft as much as the pertinent sections of the CICA Handbook (standard 3860 and other). The reader can then get an idea of the amplitude of the proposed changes and the capacity of the accounting framework to face them.

A summary of the accounting treatments proposed in the exposure draft is presented in the following scheme. We can see that the first question deals with recognition, or not, of financial instruments. The next two deal with the balance sheet and the income statement. The fourth, more detailed, addresses the measurement problem. The fifth question deals with the disclosure of information.

- Question 1 : When must we include a financial instrument in the balance sheet of an entity? (or exclude it)
- Question 2 : What amounts and what balance sheet items must we charge at the inception of the contract?
- Question 3 : What income statement items must be charged subsequent to the initial recognition?
- Question 4 : How must we measure financial assets and financial liabilities? Will we recognize gains or losses from a variation in value?
- Question 5 : What are the requirements regarding the presentation of financial information, in the body of financial statements or in the notes to financial statements?

¹² See Milburn and Hague [1997].

SCHEME - PROPOSED ACCOUNTING TREATMENTS IN THE EXPOSURE DRAFT



(*) The method to be used in calculating the recoverable value depends on the type of financial asset or liability (monetary vs non-monetary). Subsequent recovery following a write-down may be recorded. Those points are discussed at question 4.

QUESTION 1
When must we include a financial instrument in the balance sheet of an entity? (or exclude it)

Initial recognition

A financial asset or a financial liability should be recognized in an entity's balance sheet when:[E-D:.020]¹³

- a) Substantially all the risks and rewards associated with the asset or liability have been transferred to the entity; and
- b) The cost or fair value of the asset of the entity or the amount of the obligation assumed can be measured reliably.

For criteria a), the risks and rewards have been transferred to an entity when it assumes the potential for a gain or a loss associated with the instrument. This happens when a contract has been signed and the revenue from the sale of the asset, or the revenues it generates, come back to the entity, or the liability implies a promise to transfer assets. In certain cases the legal aspects of a transaction must be analysed carefully. For example, the right to make an exchange under a forward contract constitutes a financial asset that may satisfy the recognition criteria even though no transaction in the underlying financial instrument takes place until the maturity of the contract. Another example is an option: the financial instrument that would be acquired on the exercise of the option is not recognized until the option is exercised; however, the potential economic advantages associated with the evolution of the fair value of the underlying instrument (financial or not) meet the recognition criteria. The intentions of the holder concerning the exercising of an option does not affect the substance or the accounting treatment of the components of the asset. [E-D:.015, .022, .185]

For criteria b), the book value of a financial instrument can correspond to a historical base (cost) or a current base (fair value). The historical cost usually corresponds to the fair value at the time of the initial contract. The determination of the fair value of a financial instrument is addressed in question 2.

Removal from the balance sheet

The recognition criteria relative to the inclusion of a financial instrument in the balance sheet also apply when trying to determine if it should be removed. Therefore, a financial instrument for which substantially all risks and rewards associated to the asset or liability have been transferred to others must be removed from the balance sheet¹⁴. The same goes for instruments which the underlying right has expired [E-D:.028]. However, each transaction must be analysed with care to fully grasp the substance of the transfer of risks and rewards. For example, a transfer of accounts receivable involving the retention of credit risk may not meet the criteria set out in paragraph .028, thus precluding the transferor from removing the accounts receivable from its balance sheet¹⁵. [E-D:.033]

Once established that a financial instrument must be recognized in the balance sheet, the next question is how.

¹³The criteria proposed in the exposure-draft are coherent with those of standard 1000.44 of the CICA Handbook.

¹⁴To help determine if substantially all risks and rewards attached to a financial instrument have been transferred to others, the exposure-draft suggests to verify if the fair value of risks not transferred and the fair value of rewards not transferred are each inferior to 5% of the total fair value [E-D:.032].

¹⁵See EIC-9 and 54 dealing with the transfer of receivables [CICA Handbook] and paragraph .127 of the exposure-draft indicating that a gain on the restructuring of financial liabilities must be credited to income in the period in which it is recognized.

QUESTION 2

What amounts and what balance sheet items must we allocate at the inception of a contract?

At the initial recognition, the classification of different components of a financial instrument should reflect the substance of the contractual arrangement. That classification should be consistent with the definition of a financial asset, financial liability and equity instrument. [3860.18 and E-D:.049]¹⁶. Financial instruments should be measured at the fair value of the consideration given or received for it. [E-D:.071]. This value represents the historical cost.

Determining the historical cost of a financial instrument

The historical cost of a financial instrument obtained through the exchange of a sum of money is easy to determine, it corresponds to the engaged cash flows. However, an estimation of their fair value is needed when financial instruments are obtained through the exchange on non-monetary considerations.

Quoted market price may be used to assess the fair value of a financial instrument if a sufficiently active market exists. If this is not the case, one must use judgement along with the information available. For example, there are many ways to estimate the value of a financial instrument traded on a non monetary market: by adjusting the quoted market price (increasing or decreasing); by using the market value of one or many similar financial instruments (a swap may be reproduced by reciprocal loans); by discounting future cash flows at a relevant rate by applying a model like the one developed by Black and Scholes¹⁷ for the valuation of options; by asking the advice of an expert [3860.81-.85 and E-D:.019, .026, A.82].

During an examination if you have to determine the fair value of a financial instrument, I suggest you give as many alternatives as the information permits, and support each briefly. Subsequently, recommend the best alternative based on your analysis. Be careful not to get lost in too many complicated calculations, however, don't be scared to formulate assumptions (like choosing a discount rate), if necessary, to help conclude your calculations.

Sometimes a financial instrument is created following an exchange, a conversion or exercising a right. In such a case the book value of the resulting financial instrument is calculated from the book value of the asset given up. That way, all gains and losses are deferred until the instrument is sold or exchanged in the future. That is in conformity with standards 1000 and 3860 of the CICA Handbook. [E-D:.047-.048,.133]¹⁸.

Once the fair value of a financial instrument who complies with the recognition criteria has been determined, it is time to put it in the right section of the balance sheet.

Simple financial instruments

First, many financial instruments are easy to account. They are simple or primary financial instruments, who contain only one financial asset, financial liability or equity instrument. That's the case, most of the time, of liquidities, claims, debts, stocks and many operations for which a monetary consideration has been given. For example, a lender accounts a loan as an asset and the borrower as a liability, for the corresponding amount of exchanges in cash flow.

¹⁶See EIC-69, 70, 71, 72 and 74 who deal with the recognition and measure of certain financial instruments presented as a liability or an equity item.

¹⁷The main valuation factors of the fair value of an option are: the market value and the volatility of the underlying security/asset; the remaining time before term; the exercise price; the revenues paid during the life of the security; the discount rate [see 3860.A25 and Laroche and St-Cyr, 1996 pages 96-99].

¹⁸See EIC-58 "Accrued interest upon conversion of convertible debt".

Compound financial instruments

Certain compound financial instruments hold a combination of financial assets, financial liabilities and/or equity instruments. Each component must be accounted for separately by both parties [3860.24 and E-D:.041]. For example, the issuance of convertible bonds into common shares would entail these journal entries:

Cash	xx	
Bonds payable		xx
Contributed surplus - conversion privilege (In the books of the issuer)		xx
Investment - bonds	xx	
Investment - conversion feature	xx	
Cash (In the books of the holder)		xx

The global amount to account is usually easy to identify. The problem lies in the distribution of this amount between the different components. To do so, we must use our judgement along with the available information. Often, the value of one of the components can be separately calculated, allowing to deduct the other. The total fair value can also be allocated to each component in proportion of their estimated fair value. [3860.29-.30 and E-D:.045]

Distorted financial instruments

Certain financial instruments can have the appearance of a liability, but also come with the characteristics of an equity instrument, and vice versa. The substance of a financial instrument, rather than its form, governs its classification on the issuer's balance sheet. For example, certain forms of preferred shares have preferential rights in relation to dividends and are redeemable at the holder's convenience. These meet the definition of a financial liability. [3860.22 and E-D: .050-.055, A.12-.13]¹⁹

Derivative instruments

Derivative financial instruments combine the characteristics of other instruments. For example, interest rate swaps resemble to back-to-back loans; options are related to underlying assets; etc... The payment amounts relative to derivatives are determined by reference to another source rather than determined in advance. The amounts and items to allocate at the initial signature of these financial instruments must reflect their fair value and their substance, considering the possibility of netting or offsetting when applicable²⁰.

Offsetting

For certain assets who are related to financial liabilities, must we present both items separately? Or, offset them and present the net amount?

That question is particularly important because it is directly related to the amount of liabilities recognized by the entity. In fact, the ratios who contain liabilities will be affected, as well as the debt and credit image of the entity.

To fully understand what we are talking about, lets start with a simple example. If a business sells inventory on account to a client which is also a supplier, then the business could have, at the same time, a financial asset (account receivable) and a financial liability (account payable) with that same supplier. It could be tempting to offset these amounts and to present

¹⁹See EIC-13 "Preferred shares whose redemption is outside of the control of the issuer" and EIC- 50 "Special warrants convertible into common shares". Note, preferred shares for which dividends and/or redemption value are outside the control of the issuer constitute equity instruments [3860.A21].

²⁰See EIC-39 who deals with accounting for the issue of certain derivative instruments.

only the net asset or liability. This presentation is only acceptable when a “legally enforceable right to set off the recognized amounts has been provided for in the contract or otherwise”, and that “the entity intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously”. [3860.34 and E-D: .062]

In these conditions, some ‘defeasance’ situations permit offsetting and some ‘in-substance defeasance’ do not. Offsetting is permitted when ‘Defeasance’ implies that the debtor’s obligation under a debt agreement may be discharged by depositing cash or other assets with a third party that agrees to assume the debtor’s obligations permits offsetting. Offsetting is not permitted when ‘In-substance defeasance’ implies that a sum of money or other assets are transferred into trust, in order to allocate them to service the debt, without acceptance of the creditor to discharge the debt or of his contractual obligation. [3860.37, .41d and E-D: .038,.039,.067]

Let’s assume that an entity has traded an interest rate swap in which it will pay interests calculated from a floating rate whilst the other party will pay fixed interest. Suppose that the net present value (NPV) of the interest payments at the floating rate is \$ 100 000 and the NPV of payments at the fixed rate is also \$100 000 (understand why?). If the contract holds an offsetting clause (netting) meaning only the differential interests will be exchanged, then the interest figure to include in the income statement will be netted; if not the interest income and interest expense will have to be presented separately.

In a balance sheet there is no problem to recognize an asset and a liability of \$100 000 each. However, how could we show a net amount of zero? That is the very essence of certain ‘off balance sheet’ operations. Here, even though the notion of off balance sheet leads to believe non recognition, often financial assets and liabilities have in fact been (1) recognized, and (2) offset in the balance sheet. This situation occurs every time a financial instrument produces the offsetting of financial assets and liabilities with the same book value. These off balance sheet instruments include interest rate and currency swaps, forward contracts and, in certain cases, options.

It goes without saying that complementary presentation in the notes to financial statements is very important in the case of offsetted financial instruments. We will come back to it later.

If a situation like this should present itself during an examination, I suggest you clearly show you can make the distinction between recognition and offsetting, then argument and recommend.

Synthetic instruments

We can create, by combining (matching) many different financial instruments, the characteristics of a unique financial instrument. For example, an interest rate swap matched to fixed rate debt could have the effect of producing a debt transformed at a floating rate. In that case, should we present the transformed debt in the balance sheet? The answer is no because swap contracts are legally independent from loan contracts. Creditors usually hold the same rights for their loan, whether they have been matched or not to financial instruments. Moreover, swap holders are often different from the creditors for which we want to match loans.

Most of the time, securities matched to financial instruments will have to be presented according to their original conditions in the balance sheet, accompanied with notes describing the matched financial instrument and their effect (if the amounts at risk are important) [3860.41, .A26 and E-D:.067].

In an examination question, there probably would be a lot of points to identify and argument different alternatives.

That’s it for the accounting at inception of financial instruments. What do we do after?

QUESTION 3

What income statement items must be charged subsequent to initial recognition?

First, do not look for problems where there aren’t any. At inception, financial instruments are accounted in accordance with their economic substance. Consequently, the amounts received periodically or paid relative to those assets or liabilities will subsequently go in the income statement as a revenue or an expense. [3860.31]. In the same way, the periodic amounts

relative to financial instruments who have been presented at the net amount in the balance sheet, will also be offset in the income statement²¹. And the amounts relative to equity operations won't presented in the income statement under any circumstances.

Financial instruments can produce revenues or related fees such as commission or transaction fees. Once again, the accounting treatment of these revenues/expenses must reflect the substance rather than the legal form. Here are a few examples [E-D:.171,.174-.181]:

- C Fees associated with the issuance or acquisition of an asset are part of the price paid to acquire it and are usually deferred and expensed during the subsequent use rather than at the time of initial purchase (when future economic benefits may be obtained [1000.29]).
- C Financial securities are often issued at a different amount than their nominal value. For example, zero coupon bonds are issued at a discount corresponding to the present value of the theoretical interests included in the reimbursement of the nominal value at term; bonds bearing an interest rate higher than the market rate are issued at premium. These premiums/discounts are accounted as a capital adjustment at the inception of the contract and as an adjustment to returns during the life of the security.
- C Fees received relative to the signing of a contract for financial assets are accounted directly as revenues in the income statement when they are concerning services to be rendered. They are deferred and amortized when they represent an adjustment of the interest rate stipulated in the contract.²²

The historical cost of assets and liabilities implies not only the amount, but also the calculation components who have been taken into account at the initial recognition. For example, the measure of the book value of long term bonds, at each balance sheet date, must correspond to the present value of future payments at the original rate. That rate is in fact the internal rate of return calculated at the initial recognition (based on discounting all future cash flows related to the bond including related revenues/fees). In other words discounts and premiums are amortized on a basis that reflects the effective rate and not at a linear rate.[E-D:. 089,.170-.171]²³

For specific items, a little judgment is sufficient. For example, the interests on investments in certain swaps are presented under "interest revenues" in the income statement; the interests on loans and on certain swaps, as well as dividends on preferred stock shown as a financial liability in the balance sheet, are presented under "interest expenses" [3860.32-.33 and E-D:.061, .175].

We will see in question 4 that certain financial instruments can, in certain circumstances, be revalued at their fair value. The gains or losses due to the revaluation or disposal will generally be presented in the income statement.

QUESTION 4
How must we measure financial assets and financial liabilities?
Will we recognize gains or losses from a variation in value?

Actual standards and equity instruments

The exposure-draft does not deal with the subsequent measure of equity instruments. They are measured at historical cost at inception and this value is not adjusted afterwards to reflect non materialized variations. This comes from the notion that

²¹ In certain circumstances, we can offset in the income statement even if we didn't off-set in the balance sheet. For example, interest expense on a loan could be presented net of the interests relative to a swap to which it is matched. [3860.51 and E-D: .070]

²² See the accounting guideline " Fees and costs associated with lending activities" [AcG-4].

²³ See EIC-22 who favours a similar treatment in the case of extended-term debts with prepayment of interest. And EIC-47 who suggests a consistent presentation of premiums and discounts in the cash flow statement.

in Canada capital maintenance is measured in financial terms with no adjustments being made for the effect on capital of a change in the general purchasing power of the currency during the period [1000.55]. As well, gains and losses on equity instruments are excluded from net income by virtue of standard 3610 of the CICA Handbook (equity transactions). The rest of this section will exclusively be about the measure of financial assets and financial liabilities²⁴.

Measure of financial assets and liabilities (FAL)

If we were to ask different people what should be the accounting standards for FAL in the balance sheet, and by the same token, the recognition or not of gains or losses on variations of their value in the income statement this is probably what the outcome would be:

- C A conservative accountant would prefer the historical cost;
- C A financial analyst would say the market value, which could probably be found on a stock market;
- C An economist would surely opt for the fair value and might give a model to calculate it.

All could be right, but what do you think about it in the present Canadian accounting context? Maybe you are indifferent, but the Accounting Standards Committee is not! The exposure-draft recommends to classify FAL in three categories [E-D:.080]²⁵:

- C The ones held for the long-term or to maturity,
- C The ones held as hedging, to reduce financial risk, without regard to the detention period,
- C Others.

The appropriate classification for a financial instrument is based on managements' primary intention with respect to the instrument [E-D:.081]. To alleviate the text, we will use the three following categories to qualify the different intentions of management towards FAL:

- C Long-term FAL
- C Hedging FAL
- C Speculative FAL

Long-term FAL

FAL which the entity intends to keep or assume for more than a year belong to this category. Short term FAL, like accounts payable and accounts receivable for which the entity intends payment at the due date also belong to this category. Their first characteristic is that they are not held for hedging or speculating purposes.

Long-term FAL must be measured at their historical cost [E-D:.082], except in these cases:

- C When there are reductions in the value of financial assets and we estimate not being able to recuperate them in the near future. The amount of the reduction should be charged to income in the period in which it is recognized. The assets carrying amount should be reduced to their recoverable amount. [E-D:.097,.112]

²⁴See EIC-71 which is about accounting for financial instruments that may be settled at the issuer's option in cash or its own equity instruments.

²⁵In a recent article published in CA Magazine, Milburn and Hague [1997] indicate that the Accounting Standards Committee has published a working document who proposes a logical framework for measure and recognition standards of financial assets and liabilities. It proposes to value all of them at their fair value after initial recognition. Gains and losses resulting from variations in value would be recognized in the income statement. This proposition gives similar results to what was proposed in the exposure-draft of April 1994 for speculative and hedging FAL, except when financial instruments have been qualified as a hedge of either futures operations not yet being the object of any engagement or non financial engagements not recognized, either assets and liabilities accounted at cost.

- C When an asset has been written down to its estimated recoverable amount and the estimated recoverable amount subsequently increases, the write-down should be reversed to the extent of the increases. [E-D:.098, .113]

We determine losses in value of a financial asset by the difference of its historical cost and recoverable amount. This procedure must be done asset by asset, unless the entity does not have enough information, in which case we proceed by groups of assets [E-D:.106,.123]. The calculation of the recoverable amount depends on the nature of the financial asset:

- C For financial assets that should be settled by scheduled payments of fixed or determinable amounts, the recoverable amount corresponds to the estimated present value at the rate of interest inherent on initial recognition. Then, losses in value caused by increases in market interest rates in relation to effective returns of the asset are not recognized. There is a reduction of the net book value of a monetary asset uniquely when the decrease in value is the result of doubtful receivables. [E-D: .100, .102, .104]²⁶.
- C For the other financial assets (non monetary), the recoverable amount corresponds to the estimated future cash inflows that will be collected to the extent that there is no convincing proof that the book value can be recovered during the planned detention period. A situation prevailing for a period of two years is considered convincing proof. [E-D:.117, .120].

Note that the basic measure of long-term financial liabilities remains the historical cost, without accounting for subsequent gains or losses that have not yet been materialized.

All of this may seem heavy , but when we take a closer look, there really aren't any surprises. In the balance sheet all the items are accounted at historical cost at their initial recognition, and increases are hardly ever accounted until their realization (revenue recognition principle). For long term instruments, standard 3050 of the CICA Handbook already recommends that decreases in value (permanent) be recognized (conservatism principle). The only important difference between the exposure-draft and the present standards is in regards to non-materialized increases in value having the effect of cancelling previously recognized decreases. Presently we do not recognize them [3010.06 and 3050.21] but the exposure-draft proposes to do so [E-D: .098, .113].

The general measure rule for long-term FAL is historical cost, that we sometimes adjust to recognize unmaterialized losses. The logic is that we normally wait for the culmination of the realization of the earnings process to recognize increases in value other than the ones cancelling the decreases in value previously accounted.

Hedging FAL

A financial instrument should be accounted for as a hedge when [E-D:.134]²⁷

- a) The position to be hedged is specifically identified and exposes the entity to risk of loss from price changes;
- b) The instrument is specifically designated as a hedge; and
- c) It is highly probable that the changes in fair value of the instrument designated as a hedge and opposite changes in the fair value of the position being hedged will have a high degree of correlation so that the hedging instrument will be effective as a hedge.

The position to be hedged, according to criteria a), can be a financial asset or financial liability, it can result from a non

²⁶This treatment is similar to the treatment of impaired loans in standard 3025 of the CICA Handbook.

²⁷The exposure-draft on financial instruments does not apply to the coverage of foreign exchange positions. That subject is covered in standard 1650 of the CICA Handbook. However, the logic for hedge accounting is the same as for the different kinds of risks hedged.

financial asset or liability, and it can be about past or future operations [E-D:.135, .137, .145-.147]²⁸. Criteria b) makes reference to the intention of management [E-D: .139]. Criteria c) requires an estimation of the probability of price variations for both positions (hedging and hedged) throughout the hedging period. This period can cover the entire period of the position to hedge, or only a fraction of the period. Certain derivative instruments who hold an exercise price (like options) generally do not qualify as a hedge of the underlying financial asset or financial liability when they have no intrinsic value (sometimes referred to as “out of the money”)²⁹. [E-D: .143, .148-.150]

A gain or a loss from a change in the fair value of a financial instrument accounted for as a hedge should be recognized in income at the same time as the corresponding loss or gain from a change in the fair value of the hedged position is recognized [E-D:.151]³⁰. In that same way, the gains of one are compensated by the losses of the other and vice versa. We can account hedge instruments on the basis of historical cost or on the basis of fair value, while deferring, if need be, non realized gains or losses. [E-D: .153, .155]³¹. Changes in the time value of derivative instruments, who are not generally correlated with the variations in fair value of the hedged position, are recognized to income during the hedging period. The principle is that hedge accounting is only applicable to the specified hedged risk, and not to other risks possibly brought on by the traded positions. [E-D: .156-.157]³²

Hedge accounting is a question of logic. A hedge operation’s goals is to reduce certain risks assumed by the entity, and by the way to reduce the variability of its income. Would accounting play its role properly if it produced skewed results for hedges and hedged positions? For example: if an entity is scared of incurring a \$300 loss on a financial instrument, which would be accounted in the income statement in three years, and it buys a hedge instrument that will have the effect of realizing a symmetric gain in three years, then that \$300 gain on the hedge instrument should be recognized in the income statement at the same time as the loss on the hedged instrument, in three years. The annual recognition of part of the gain from the hedge instrument would have the effect of increasing the comparable variability of income, when in fact the economic variability has been reduced! Hedge accounting is about matching accounting losses and gains in a way that reflects the economic reality that they are related to.

Speculative FAL

A FAL is considered belonging to the “speculative” category when it does not answer to the conditions of the other two categories [E-D: .163]. Here, the exposure-draft is less explicit on characteristics related to those instruments, but we can still deduct that the FAL instruments touched are held for speculative reasons. They can be primary instruments, secondary or derivative, and they are often held for a short period of time.

The propositions of the exposure-draft for speculative FAL are: 1) they should be measured at their fair value and 2) the resulting gains or losses should be recognized to income when they occur [E-D: .163-.164].

²⁸An example of a position to hedge other than a financial asset or a financial liability is the account receivable that will result of a future sale of merchandises held today.

²⁹A purchase option is traded out of the money when the exercise price is higher than the fair value of the underlying asset. It is traded in the money when the exercise price is lower than the underlying asset. In that last case, the difference between the two amounts corresponds to the “intrinsic value”. It is the immediate saving that a person would realise by purchasing the underlying asset and by paying the exercise price rather than paying the market price. An option is usually traded at a higher value than its intrinsic value to take into account the supplementary speculative amount that could be benefitted from in the future (“time value”). [3860.A24]

³⁰That treatment, proposed in the exposure-draft, is similar to the one recommended in standard 1650 of the CICA Handbook as well as the one in the exposure-draft on currency exchange [May 1996]. Also see EIC-57 “Spot deferred forward contracts”. In the case where a hedge is not perfect, we still apply the same symmetrical accounting treatment [E-D: .154].

³¹See EIC-56 “Exchangeable debentures”.

³²The variations in the time value are amortized into income over the term of the contract when the instrument is used to hedge a FAL held long term or position arising from an anticipated future transaction. [E- D: A.45-.46]. They are recognized to income as soon as they occur when the instrument is used to hedge a speculative position FAL [E-D:.156].

Maybe you thought you could be able to figure out the accounting treatment of speculative FAL by referring to the present rule of standard 3010 of the CICA Handbook which is about temporary investments (who are related to speculative FAL)!?! Well, if that is your case, now you see that the exposure-draft is different than the actual rules; we have to give standard setters a little room for creativity! The difference with that standard is that not only are decreases in value accounted for, but increases as well. The rationale is consequent with the nature of most FAL included in this category since they are held for speculative reasons, and that the fair value is really the one users are interested in. However, this proposition by the exposure-draft is really at the forefront of the evolution of accounting standards. It could constitute, if retained, a major change in standard setting which is contrary to the traditional principles of conservatism and historical cost.

Reclassification

A reclassification occurs when an FAL changes of category. If the basis for measure is unchanged, there is no problem. It's the case when a FAL goes : from being held "long term" to the "hedging of a long-term FAL"; from the "speculative" category to the "hedging of a speculative FAL" ; or vice versa.

When the base measure of a FAL changes, we have a problem with the treatment of the new and the old book value. Must we recognize this difference in the income statement or defer it in the balance sheet? This happens when a FAL goes: from the category of being held "long term" to the "speculative" or "hedging of a speculative FAL"; from the "Speculative" category to the category of being held "long term" or "hedging of a long-term FAL"; or vice versa. The exposure-draft recommends this:

- C Any gains or losses resulting in a change of the measurement basis should be recognized in income in the period of the reclassification and disclosed separately, except when of abandoning hedge accounting [E-D:166]
- C Before stopping hedge accounting, we do not change the treatment planned for deferred gains or losses who have been previously accumulated [E-D: .158]. This respects the notion of change in accounting estimate presented in the standard 1506 of the CICA Handbook.

We have just seen the impact of the measure of financial instruments on income. Are there other presentation rules? In particular for off-balance sheet instruments, how must we inform readers? This is answered this in question 5.

QUESTION 5

What are the requirements regarding the presentation of financial information, in the body of the financial statements or in the notes?

Evidently there are a lot, whether financial instruments have been recognized or not. However, we must not forget to use our judgement and to appreciate the materiality of the operations before preparing the accounting information. Standard 3860 and/or the exposure-drafts on financial instruments [1994] and currency exchange [1996] recommend to give out the following information:

- C Accounting policies, including the criteria applied in determining when to recognize a financial asset or a financial liability on the balance sheet, and when to cease to recognize it. [3860.48]
- C A general description, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows (interest rates, par value, cash, restrictive clauses, etc.) [3860.52 and E-D: .191].
- C Exposure to interest rate risk, including contractual repricing or maturity dates and effective interest rates (showing the net exposure to interest rate risk to contractual repricing or maturity dates, including off-balance sheet items) [3860.57 and E-D: .199].
- C Foreign exchange risk, including the net amount of exchange gains and losses recognized in the income statement,

as well as the ones not realized on long term monetary items [E-D on currency exchange: .101, .103]³³.

- C Credit risk, including the amount that best represents the maximum credit risk exposure at the balance sheet date of an entity, without taking account of the fair value of any collateral, in the event other parties fail to perform their obligations under financial instruments; and significant concentrations of credit risk (who could default on their obligations at the same time) [3860.67 and E-D: .206].
- C Fair values, or at least the principal characteristics needed to determine them when it is not practicable to do the estimation within reasonable constraints of timeliness or cost. [3860.78 and E-D: .217]³⁴.
- C Other information, including the reasons that justify the non accounting of a decrease in value judged temporary; information on the accounting of decreases in value and on write-down subsequently reversed; information on hedging for anticipated future transactions [3860.89, .92 and E-D: .112, .166, .221-.222, .226].

A particular attention should be put on the presentation of off-balance sheet financial instruments such as derivatives. In fact, they are the one susceptible of revealing important risks not disclosed in the body of the financial statements!

The disclosure requirements of financial instruments are coherent with the present standards 3280 and 3290 of the CICA Handbook on contractual obligations and contingencies³⁵. The information to disclose is more detailed but still holds the same objective: disclose relevant information to respond to the needs of users.

Finally, certain transactions hold financial instruments who imply related parties, like back-to-back loans for which parties have mutual agreements to benefit from arbitrage savings. In these cases, information description and amounts of operations between related parties must be disclosed by virtue of standard 3840.

³³It would also be useful to show the entity's net exposure to foreign currency exchange by currency, including off-balance sheet items.

³⁴This is coherent with the presentation of the market value already provided for long term and short term investments [3010.05 and 3050.33].

³⁵ Standard 3280 recommends that particulars of any contractual obligations that are significant in relation to the current financial position or future operations should be disclosed. These engagements are diverse in nature: commitments that involve a high degree of speculative risk, where the taking of such risks is not inherent in the nature of the business; commitments to make expenditures that are abnormal in relation to the financial position or usual business operations, e.g., commitments for substantial fixed asset expenditures (where a figure for approved expenditures is more significant, the total appropriation may be stated instead of the commitment); commitments to issue shares (see "Share capital", 3240.03); commitments that will govern the level of a certain type of expenditure for a considerable period into the future [3280.01].

Standard 3290 recommends that the existence of contingent losses at the date of the financial statements should be disclosed in notes to the financial statements. A contingency is defined as an existing condition or situation involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. The amount of contingent losses that are likely to be confirmed by future events and that can be reasonably estimated should be accrued in the financial statements by a charge to income and by a liability in the balance sheet. Normally, contingent gains are not accrued in the financial statements. [3290.02, .12, .15, .20] See EIC-70 who deals with the presentation of a financial instrument when a future event or circumstance may affect the issuer's obligations.

OBJECTIVE V - HOW TO REACT DURING AN EXAMINATION³⁶?

Suggested attitude: Do not panic!

Directing principle: Get the easy points first. Then address the most difficult ones.

Proposed approach:

- 1- Recognize and identify the problems.
- 2- Find out the objectives of the parties implicated (management, creditors, stockholders, unions, etc.) and their needs.
- 3- Make sure that the materiality of the objectives at hand are great enough.
- 4- Refer to practices in use (CICA Handbook and others) and the exposure-draft on financial instruments. Do not hesitate to refer to the conceptual framework and generally accepted accounting principles (economic substance, historical cost, conservatism, realization).
- 5- Identify and argument alternative accounting treatments. There are often many points for different options, including the ones that are not kept. It is important, when possible, to include calculations to quantify the ~~imp~~ impact on financial statements.
- 6- Make a recommendation, parallel to the analysis, and do not forget complementary disclosure in the notes to financial statements.

Discussion elements:

Here are the main concepts at the base of standard 3860 and the exposure-draft:

- C The goal of accounting information is to respond to the financial needs of interested users in understanding, not only the results, but also the risks.
- C Accounting must reflect the substance of a transaction rather than its form (substance over form principle). A good example is recognizing preferred shares as a liability.
- C The fundamental accounting stakes of financial instruments are recognition, measure and presentation.

The main changes proposed by the exposure-draft, relative to the practices currently in use, are as follows:

- C The exposure draft recommends accounting for speculative financial assets and liabilities at their fair value, and

³⁶Here is a list of financial instruments questioned in the UFE, the CMA entrance exam or CGA examination of financial accounting FA-4:

- C Derivatives (UFE 1996, paper II, question 4)
- C Loans (UFE 1996, paper IV, question 2; CMA 1990, question 3)
- C Securities (CGA, December 1996, question 3)
- C Securities (CMA 1995, question 1.7; CMA 1994, question 3.2)
- C Options, swaps (UFE 1993, paper III, question 6; UFE 1990, paper III, question 3)
- C Risk and equity (CMA 1993, question 4.5 and 4.6)
- C Convertible debentures (UFE 1989, paper IV, question 2)

the recognition in the income statement of their non materialized increases in value. (No doubt the most important change).

- C The exposure-draft allows the recording of increase in value of long term financial assets up to a point where it has the effect of cancelling previously recorded decreases in value.
- C The exposure-draft has accounting rules for the recording of hedge financial instruments; they are added to the existing ones and are similar to the ones found in standard 1650 of the CICA Handbook for foreign currency hedging.
- C The exposure-draft recommends to amortize premiums and discounts according to the effective rate method.
- C As a whole, the exposure-draft demands more details than the present standards, especially with respect to notes to financial statements, interest rate and credit risks.

Here is s critique of the exposure-draft:

- C The proposed standards permit manipulation of the accounting information. As a matter of fact, for financial information to be useful it must be reliable and relevant. Information is reliable when it is in agreement with the actual underlying transactions and events, and is exempt of error and bias; information is relevant when it can help users make decisions.

The exposure-draft holds many situations where judgement and management's intention is needed. In one respect it permits a better representation of the substance of transactions, but in another, it permits management to choose accounting treatments oriented towards their particular interests³⁷.

- C The proposed standards are susceptible of creating confusion and incoherences with the present standards. The exposure-draft gives a lot of recommendations and explanations. It contains 231 paragraphs of recommendations and suggestions, and an appendix of 93 paragraphs with examples demonstrating the application. Among the proposed standards, the recognition of gains on instruments for speculation is a precedent far from the actual standards, and the principles of conservatism and historical cost. The recognition of increases in value not yet materialized with the effect of cancelling decreases in value previously recorded also constitutes a big change from the present standards. It is true that detailed standards allow for a better accounting treatment of operations. However, it entails a high degree of details that may not necessarily always fit the economic reality of certain operations. This is even more true in the case of derivative financial instruments, who in many cases were created to overcome tax, legal or accounting rules.

³⁷Positive accounting theory explains how multiple accounting treatments allow managers to choose the ones that will maximize their interests [Watts & Zimmermen, 1986]. This could favour economic transfers of wealth more or less desirable between users/economic agents.

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