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Impact of IFRS on the Banking Industry

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FINANCIAL SERVICES

Canadian banks are required to adopt IFRS in 2011—but some key standards are still moving targets. Carefully assess the potential impact of any changes.

Canadian public companies are required to adopt International Financial Reporting Standards (IFRS) for years beginning on or after January 1, 2011. For Canadian banks with an October 31 year end, adoption will occur beginning November 1, 2011. The regulator also requires banks to file their reconciliation of retained earnings from Canadian GAAP to IFRS in their progress reports six months after transition. making the actual timing even tighter.

Numerous exposure drafts demonstrate that standards will continue to change in the near term as well as in 2012 and beyond. Canadian banks need to think carefully about the implications of upcoming changes as well as changes likely to occur after their 2011 changeover to IFRS.

Key Accounting Issues

Although Canadian accounting standards are similar to IFRS in certain respects, many differences exist. These differences can be significant and have enterprise-wide implications.

As a further complication for Canadian banks, the International Accounting Standards Board (IASB) is currently deliberating some significant accounting changes, This publication highlights those areas where further change is likely.

Replacement of IAS 39

In response to the global credit crisis, the IASB is currently in the process of replacing IAS 39, the accounting standard for most financial instrument-related matters.

The project has three phases:

- Classification and measurement
- Impairment
- Hedge accounting.

In addition, the IASB has fast-tracked related projects on topics such as credit risk, derecognition, fair value measurement, and impairment of financial instruments.

Financial Instruments: Classification and Measurement

On July 14, 2009, the IASB issued exposure draft (ED) *Financial Instruments: Classification and Measurement*.

The IASB proposes two primary measurement categories for financial assets and financial liabilities: amortized cost and fair value.

It eliminates the held to maturity, available for sale, and loans and receivables categories. It also eliminates the exception that requires unquoted equity instruments and related derivatives for which a fair value cannot be reliably determined to be measured at cost. Under the proposals, such instruments would now be required to be measured at fair value. The ED retains the current requirements in IAS 39 to measure all financial instruments that are held for trading, including derivatives that are not designated as hedges, at fair value through profit or loss.

The classification of a financial instrument would be assessed upon initial recognition. To qualify for measurement at amortized cost, a financial instrument must have only basic loan features and be managed on a contractual yield basis.

Basic loan features

Basic loan features are contractual terms that give rise on specified dates to cash flows that are payments of principal and interest on the principal outstanding. Interest represents consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time.

Managed on a contractual basis

Financial instruments are managed on a contractual yield basis only if they are managed, and their performance evaluated, by the entity's key management personnel, on the basis of the contractual cash flows that are generated when held or issued.

Financial assets that are acquired at a discount that reflects incurred credit losses are deemed, under the ED, not to be managed on a contractual yield basis.

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Fair value option

The proposals allow an entity the option to designate at fair value, through profit or loss, an instrument that otherwise would be measured at amortized cost. This election is irrevocable and is available only upon initial recognition, and only if it eliminates or significantly reduces a measurement or recognition inconsistency ("accounting mismatch"). This election is retained from IAS 39.

Hybrid contracts and embedded derivatives

The proposals also change the accounting for hybrid financial instruments; derivatives embedded in such contracts are never separated from the host financial instrument. Instead, the hybrid financial instrument is assessed in its entirety as to whether it should be measured at amortized cost or fair value. In our view, it is likely that most hybrid instruments with embedded derivatives that are currently separated would not qualify as basic loans.

Investments in equity instruments

Investments in equity instruments do not possess basic loan features and therefore are measured at fair value. For investments in equity instruments that are not held for trading, the ED provides an irrevocable choice upon initial recognition to recognize all fair value changes and dividend income from the investment in other comprehensive income (OCI). No amount (including dividend income or impairments) recognized in OCI is ever transferred to profit or loss at a later date when the securities are sold.

Canadian banks will have to reassess their investments in debt and equity securities and their own obligations based on the new classification and measurement guidance on the date of initial application. To the extent that securities no longer qualify for accounting at amortized cost, there will likely be more income statement volatility.

Impairment of Financial Assets

An ED to amend the impairment provisions in IAS 39 is scheduled for October 2009. Like Canadian GAAP, IFRS currently has an incurred loss model for debt securities and loans; unlike Canadian GAAP, an impairment charge is recognized when there is objective evidence of impairment—no consideration is given to where the impairment is other than temporary.

The IASB has issued a request for information on the feasibility of an expected cash flow approach to impairment as a possible approach to replace the incurred loss model. This model would require an entity to make an ongoing assessment of expected (current and future) credit losses, which may require earlier recognition of credit losses. Related systems may need to be modified to account for the change in approach to impairment.

Hedging

With respect to hedge accounting, IFRS does not permit the use of the short-cut method and permits the use of the critical terms method only for prospective assessments of hedge effectiveness. Canadian banks will have to evaluate, on transition, whether hedges are of a type that qualify under IAS 39 and change hedge documentation as appropriate. For those hedging relationships that are not of a type that qualify for hedge accounting, previous hedge accounting will have to be unwound upon transition. As indicated earlier, hedging is one component of the IAS 39 replacement project. While the IASB currently has indicated that hedge accounting should continue to be permitted, at the time of publishing, there is little, if any, clarity around what the final proposals will entail. In December 2009, the IASB plans to publish an exposure draft on hedge accounting.

Effective date and transition

The IASB expects that the final standards for financial instruments, impairments, and hedging will not be mandatorily effective before fiscal years beginning on or after January 2012. Recent proposals by the Office of Superintendent of Financial Institutions would preclude Canadian banks from early adopting these standards on transition to IFRS.

Derecognition of Financial Assets

(Including securitizations, repurchase, and securities lending transactions)

The IASB issued an ED, *Derecognition,* on March 31, 2009. The proposed approach is different from the current requirements in IAS 39 in that it does not combine elements of several derecognition concepts. Rather, it focuses on a single element—control. An entity would derecognize a financial asset when the future economic benefits cease to exist, or where the future economic benefits exist but the entity ceases to have the ability to (a) obtain future economic benefits and (b) restrict others' access to those benefits.

The principles in the ED, which determine whether a transfer of financial assets results in the derecognition of the transferred assets, may appear to be in line with Canadian GAAP, as they are based on control. However, where a transferor has continuing involvement with the transferred asset (e.g., a retained interest therein), the transferee must have the practical ability to sell the asset onward for its own benefit. Our experience suggests that such practical ability does not exist, and accordingly, even under proposed standards, off-balance sheet treatment may not exist.

Consolidation, Variable Interest Entities (VIE), and Special Purpose Entities (SPE)

The IASB issued an ED, *Consolidated Financial Statements,* on December 18, 2008. The ED proposes a single control model for all entities, including "structured entities," which would replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities.* These proposals are not designed to converge with US GAAP, but the IASB and the US Financial Accounting Standards Board plan to converge their respective consolidation projects at a later stage. The proposals define control as "the *power* of a reporting entity to direct the activities of another entity to generate *returns* for the reporting entity."

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Power

The proposals refer to a reporting entity having power if it can "determine the other entity's strategic operating and financing policies," wherein power can be held in a number of ways. This concept of power is potentially broader than the current standard. For example, options that are not currently exercisable would be taken into consideration.

The ED also refers to the assessment of other arrangements that might convey power, but emphasizes that economic dependence in itself does not give power. All facts and circumstances must be assessed in determining if the reporting entity has power.

The proposals also indicate that a reporting entity can have the power to control another entity by virtue of it being the dominant shareholder, when other voting interests are widely dispersed and are not organized to act in concert.

Returns

The proposals indicate that returns "vary with the activities of an entity and can be positive or negative." The concept of returns is very broad, covering not only the traditional ownership benefits (e.g., dividends) that in our view are the basis of the current standard, but also returns such as fees, tax benefits, access to liquidity, and achieving economies of scale.

Structured Entities

The ED introduces the term "structured entity" (SE), describing it as an entity whose activities are restricted because they are not directed through the exercise of voting rights or other arrangements. While SEs have characteristics similar to special purpose entities, it is unclear whether the application of its definition will cause more or fewer entities to be captured within this scope.

The proposals include indicators of control specific to a structured entity, for example, the SE's purpose and design, the reporting entity's returns from its involvement with the SE, the SE's activities and the extent to which its policies are predetermined, and the reporting entity's ability to change any restrictions or predetermined policies.

Fair Value Measurement

The IASB published an ED on *Fair Value Measurement* in May 2009. The proposals in the ED are intended to provide a unified definition of fair value, as well as further authoritative guidance on application of fair value measurement in inactive markets. It does not provide guidance on when to measure fair value. The proposals are largely consistent with *US Statement of Financial Accounting Standards No. 157* (SFAS 157), as well as recent guidance on fair value measurement published by the FASB.

The ED defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, i.e., an exit price. In the absence of an actual transaction at the measurement date, a fair value measurement assumes a hypothetical transaction in the most advantageous market for the asset or liability.

As does SFAS 157, the ED provides a fair value hierarchy that prioritizes into three levels the inputs to valuation techniques used to measure fair value. It is the level that then dictates the nature and extent of required disclosures.

For Canadian banks, the disclosure requirements are onerous. Also, tracking of financial assets and financial liabilities by level may require changes to infrastructure.

A final standard is expected in 2010.

First-Time Adoption of IFRS

Standards for first-time adoption of IFRS, as contained in IFRS 1, generally require retrospective application as though the entity always applied IFRS, with restatement of comparative figures. While the requirements of retrospective application are relatively onerous, IFRS 1 also contains certain mandatory and elective exemptions to retrospective application that should be thoroughly evaluated.

Many Canadian banks with foreign subsidiaries that have transitioned to IFRS before their parent will also need to consider special transition rules, including complex elective exemptions for measuring a subsidiary's assets and liabilities at the transition date.

Canadian banks that are subsidiaries of European banks are already preparing IFRS financial information for group reporting purposes. These banks are permitted, under IFRS 1, to use their parent company's 2004 transition date for their adoption of IFRS for Canadian regulatory purposes. On the surface, such an option appears appealing, as it avoids the risk of maintaining two sets of IFRS books, one for local reporting and one for group reporting. However, given the size of their Canadian operations, many institutions may have recorded, for group recording purposes, only the most significant IFRS adjustments. As a result, considerable efforts will still be necessary to assess the completeness of the IFRS transition adjustments. Despite the available elective exemption under IFRS 1, many such organizations will choose to transition to IFRS on similar timelines as other Canadian companies.

Regulatory and Business Implications

OSFI has issued guidance regarding its expectations of federally regulated financial institutions ("FRFIs") on adoption of IFRS, and has required that FRFIs submit to OSFI semi-annual progress reviews on their IFRS implementation plans.

As there are recognition, measurement, and classification differences between Canadian GAAP and IFRS, adoption of IFRS by Canadian banks may have regulatory capital implications.

Changes to implement IFRS may affect areas of the business other than financial reporting (e.g., debt covenants and other legal contracts that reference accounting information and metrics). Bonuses and compensation arrangements may also be affected, and IT systems modifications may be necessary.

One thing is clear—2011 is not very far away!

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How Can KPMG Help?

KPMG has helped many organizations assess the impact of IFRS and implement it. We have an established conversion methodology that incorporates the different disciplines critical to a successful implementation. KPMG's IFRS conversion services teams are multi-disciplinary teams comprised of professionals with industry experience, knowledgeable in IFRS and Canadian GAAP and skilled in financial reporting processes and financial integration. Our teams are supported by internationally trained professionals with global experience in both converting to IFRS and applying IFRS.

For a full description of our conversion services, refer to our publication, *Managing the Transition to IFRS: Positioning for success*, available at www.kpmg.ca/ifrs. To learn more about our IFRS conversion services for banks, please contact your local KPMG office or Mark Smith, National Industry Leader, Financial Services at (416) 777-3395, marklsmith@kpmg.ca.

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