NOTICE FROM THE AUTORITÉ DES MARCHÉS FINANCIERS

PRELIMINARY NOTICE RELATING TO THE APPLICATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS): ACCOUNTING PRACTICES AND CAPITAL ADEQUACY REQUIREMENTS

1. Scope

This Notice is intended for financial institutions[1] ("institutions") constituted or continued under a law of Québec and governed by any of the following Acts:

- *An Act respecting insurance*, R.S.Q., c. A-32
- An Act respecting financial services cooperatives, R.S.Q., c. C-67.3
- An Act respecting trust companies and savings companies, R.S.Q., c. S-29.01[2]

2. Introduction

The *Autorité des marchés financiers* ("AMF") seeks to convey to institutions its guidance regarding the implementation of IFRS. IFRSs will become the basis of preparation of financial statements for fiscal years beginning on or after January 1, 2011. For the purposes hereof, the dates used as examples apply to entities with a December 31 year-end. As such, the **date of transition** for these entities is January 1, 2010 and the **conversion date** will be January 1, 2011.

The AMF outlines its position with regard to the following:

- initial adoption of IFRS;
- information requirement for second IFRS progress report issued subsequent to the date of transition (July 31, 2010);
- accounting practices and capital adequacy requirements.

The guidance contained in this Notice is based on IFRSs in effect as at December 31, 2009. The AMF is not authorizing, for institutions covered by this Notice, the early adoption of IFRS standards issued by the International Accounting Standards Board (IASB) that may come into effect after 2011. This approach is harmonized with that recommended for all federal financial institutions.

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1 In the case of member credit unions of a federation, the guidance in this Notice applies to the "entity" as defined in the scope of the *Ligne directrice sur les normes relatives à la suffisance du capital de base* (Capital Adequacy Guideline). However, the generic term "institution" is used for purposes of applying the guidance.

2 The AMF expects trust and savings companies to apply IFRSs pertaining to consolidation set out in this Notice, even though the information contained in the annual statement must be reported on a non-consolidated basis.

3. Initial adoption of IFRS

The adoption of IFRS results in the full retrospective application of all IFRS standards in effect as of the closing statement of financial position date (i.e., December 31, 2011). Since the retrospective application of IFRS may not always be practical, IFRS 1 was issued to provide some relief.

More specifically, the objective of IFRS 1 - *First-time Adoption of International Financial Reporting Standards* is to ensure that an entity's first IFRS financial statements, and its interim financial reports for part of the period that those financial statements cover, contain high-quality information that:

- is transparent for users and comparable over all periods presented;
- provides a suitable starting point for accounting in accordance with IFRS; and
- can be generated at a cost that does not exceed the benefits to users.

IFRS 1 contains optional exemptions that provide practical accommodations to help make first-time adoption less onerous. This standard also provides mandatory exceptions to prevent the use of hindsight and the application of successive versions of the same standards.

On the conversion date (January 1, 2011), institutions should have made their choices available under IFRS 1. The AMF will require them to submit a report that reconciles equity at the date of transition to IFRS (January 1, 2010). This report must be submitted no later than the filing deadline for the first interim reporting form required for 2011.

The choices made by an institution with respect to the IFRS 1 exemptions will impact the opening retained earnings, which will, in turn, have an impact on capital requirements. Unless not specifically mentioned in this notice, the AMF expects the impact of the application of IFRS 1 to be taken into account in the calculation of required capital.

4. Information requirement for second IFRS progress report issued subsequent to the date of transition (July 31, 2010)

An institution's first financial statements under IFRS (December 31, 2011) must include a reconciliation of equity as reported in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") and IFRS. This reconciliation must report changes in the institution's equity at the time of transition (January 1, 2010), namely, reconciliation of equity as at December 31, 2009 (under Canadian GAAP) and at the date of transition to IFRS (January 1, 2010).

IFRSs do not require entities to report the comparative IFRS financial statements prior to the conversion date. Therefore, to ensure that institutions provide a timely assessment of the impacts of this transition on opening equity, the AMF requires that they file a reconciliation of their equity at the date of transition along with accompanying explanations. This reconciliation of equity should be presented in the second progress report issued subsequent to the date of transition to IFRS. Since progress reports must be sent to the AMF no later than one month after the end of each six-month period, institutions with a December 31 year-end must submit this reconciliation to the AMF no later than July 31, 2010.

The reconciliation of equity must provide sufficient detail to enable the AMF to understand material adjustments to the statement of financial position.

5. Accounting practices and capital adequacy requirements

- **Securitization and segregated funds**

The application by institutions of International Accounting Standard (IAS) 27, *Consolidated and Separate Financial Statements* and Standing Interpretations Committee (SIC) 12, *Consolidation – Special Purpose Entities* will likely require them to report in their financial statements certain securitizations that would not have been reported under Canadian GAAP. IAS 39, *Financial Instruments: Recognition and Measurement*, which addresses the conditions for derecognition of a financial asset, appears to be more restrictive than current Canadian standards. The application of IAS 27, SIC 12 and IAS 39 could therefore increase the assets of certain institutions.

Segregated funds

Current accounting standards require the financial statements of segregated funds of insurers in insurance of persons (also referred to as "life and health insurers") to be presented separately from the financial statements of the general fund. However, IFRSs do not specifically address accounting for segregated funds.

Consequently, under IFRS, life and health insurers may be required to consolidate their segregated funds into the general fund. The AMF expects these insurers to report their segregated fund assets and liabilities through a one-line reporting item. Given the current capital adequacy requirement to consider segregated fund risk, no additional requirement will apply to segregated fund assets and liabilities reported in the statement of financial position.

Securitization and special purpose entities

IFRSs could require institutions to consolidate securitizations and off balance sheet structures. If so, the AMF expects that the Asset-to-Capital Multiple of financial services cooperatives will increase. The application of IFRSs could therefore be complex.

Consequently, insured mortgages securitized through the Canada Mortgage and Housing Corporation's (CMHC's) *National Housing Act* (NHA) Mortgage Backed Securities and Canada Mortgage Bond Programs (MBS/CMB Programs) are unlikely to achieve derecognition and will therefore be brought on the statement of financial position under IFRSs.

Given the expected impacts on the Asset-to-Capital Multiple as a result of the changeover to IFRS, the AMF will permit institutions to exclude mortgages sold through the MBS/CMB Programs up to and including December 31, 2009 from the Asset-to-Capital Multiple calculation, regardless of whether they are brought onto the statement of financial position under IFRSs. If so, institutions will be required to exclude pre December 31, 2009 MBS/CMB Programs from the assets in the Asset-to-Capital Multiple calculation.

Moreover, to ensure that the result of the Asset-to-Capital Multiple calculation reflects the calculation reported in the statement of financial position, MBS/CMB exposures occurring after December 31, 2009 will be included in the calculation of the Asset-to-Capital Multiple[3] if (but only if) they are accounted for as statement of financial position exposures under IFRSs. Irrespective of the IFRS determination of what is on this statement, the AMF considers that the Asset-to-Capital Multiple should reflect the MBS/CMB originator's risk profile. Where the risk profile of the MBS/CMB originator is not materially improved by participation in such a securitization, continued inclusion in the Asset-to-Capital Multiple may be appropriate.

The AMF does not expect to make any changes to non capital reporting forms. Therefore, financial statements must be prepared in accordance with IFRSs, and institutions will be required to adjust their assets included in their Asset-to-Capital Multiple calculation to give effect to the transition provisions.

- **Insurance contracts**

IFRS 4, *Insurance Contracts* is the first standard from the IASB applicable to insurance contracts. The purpose of IFRS 4 is to improve financial disclosure, recognition and measurement criteria for insurance contracts. It applies to all insurance contracts (including reinsurance contracts) issued by an entity, as well as to all reinsurance contracts to which it is a party.

IFRS 4 is a first step towards a more comprehensive standard, which is currently under development (Phase II). The AMF does not expect this new standard to become effective before 2013. Institutions should therefore apply the current version of the standard when adopting IFRSs.

Canadian GAAP requires that life and health insurers value their policy liabilities using the Canadian Asset Liability Method (CALM). The current IFRS 4 permits insurers to use CALM to value insurance contract liabilities. The AMF expects that these insurers will be able to continue to use CALM[4] to value insurance contract liabilities when adopting IFRSs.

Financial instruments, service contracts and financial guarantee type insurance contracts

Given the definition of an "insurance contract" in IFRS 4, insurers will be required to recognize certain contracts or contract components in accordance with IAS 39, *Financial Instruments: Recognition and Measurement* and IAS 18, *Revenue.*

For contracts that are currently recognized under CALM and that will be reclassified as financial instruments or service contracts, required capital should be calculated using values determined under CALM. The amount of capital available will be adjusted accordingly.

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[3] Under the definition of Asset-to-Capital Multiple in effect when IFRSs are adopted.

[4] Under paragraph 22 of IFRS 4, "An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs."

Participating insurance

Under IFRS 4, life and health insurers have the option to treat discretionary participation features as part of the insurance liability or to show them as a separate component of equity.

If an insurer wants, and is able to, elect an equity treatment for its discretionary participation features, it must offset the impact of this election on the calculation of required and available capital.

Option to use shadow accounting practices

An insurer that elects to use shadow accounting practices should offset the impact of this method in the calculation of required and available capital.

Ceded reinsurance

Under IFRS 4, ceded reinsurance assets may not be offset by corresponding liabilities. This method of presentation is different from that used currently by Canadian life and health insurers. Capital adequacy requirements will continue to take into account ceded reinsurance. Consequently, no additional requirement will apply to ceded reinsurance assets reported on the balance sheet.

- **Investment property**

IAS 40, *Investment Property* prescribes the accounting treatment for investment property. Under this standard, investment property must be recognized using the fair value model or the cost model. The use of the fair value model will enable institutions to include unrealized gains and losses directly in the income statement.

The AMF intends to allow institutions to use the model of their choice, and will require that any gains or losses upon transition and subsequent revaluation gains and losses be included in the calculation of required capital.

- **Property, plant and equipment**

IAS 16, *Property, Plant and Equipment* sets out guidance for the recognition of property, plant and equipment. In accordance with this standard, property, plant and equipment must be recognized using the cost model or the revaluation model.

The AMF intends to allow institutions to use the model of their choice, and will require that any gains or losses upon transition and subsequent revaluation gains and losses be excluded from the calculation of required capital. The AMF is of the opinion that property, plant and equipment are assets that cannot be sold without disrupting an institution's activities.

- **Financial instruments – fair value option**

Further to the release by the CICA of Section 3855 *Financial instruments—Recognition and Measurement*, the AMF published in its Bulletin a Notice entitled "Notice relating to the "fair value option" allowing the designation of a financial instrument as "held for trading" upon initial recognition."[5] This Notice limits the situations where financial institutions may designate a financial instrument as *held for trading*.[6] The classification of a financial instrument in this category allows institutions to recognize unrealized gains and losses directly in the income statement.

The AMF considers that the limitations set out in this Notice will continue to be relevant under IFRS and that only consequential amendments will be required to delete direct quotes of IAS 39, *Financial Instruments: Recognition and Measurement* and IFRS 7, *Financial Instruments: Disclosure*.

6. Transition provisions

Due to the anticipated impact on capital adequacy requirements for certain institutions as a result of the implementation of IFRSs in Canada, transition provisions may be considered. Therefore, institutions are urged to notify the AMF if they anticipate a material impact on capital. A decision about the adoption of transition provisions will be made further to an analysis of the information submitted by institutions.

7. Other considerations

For fiscal periods beginning on or after January 1, 2011, damage (P&C) insurers should also file the regulatory return on a consolidated basis. The Minimum Capital Test (capital adequacy requirements) is currently structured to include capital available and required capital from qualified subsidiaries, and will be modified to take into account consolidated reporting returns. The AMF is of the opinion that this change should not have a material impact on damage insurers' calculation of capital adequacy requirements.

8. IASB initiatives

In 2009, the IASB and the Financial Accounting Standards Board in the U.S. ("FASB") reaffirmed their intention to collaborate to improve and converge their respective financial reporting standards. As a result, certain IFRSs are under review and institutions may be required to apply new standards when preparing their financial statements for the first reporting period. The AMF may amend the guidance provided in this Notice to reflect new requirements of IFRS. The AMF is closely monitoring the work of the IASB and will notify institutions of any changes to the guidance in this Notice.

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[5] The Notice was initially published in September 2006 and reviewed in November 2007 and December 2009.

[6] According to the definition in paragraph 19(f) of Section 3855 of the CICA Handbook.

Further information

Further information is available from:

Chantale Bégin, C.A.
Standards and Business Intelligence Division
Autorité des marchés financiers
Québec City: 418-525-0337, ext. 4595
Toll-free: 1-877-525-0337, ext. 4595
E-mail: chantale.begin@lautorite.qc.ca

Yvan Rabouin, C.A.
Standards and Business Intelligence Division
Autorité des marchés financiers
Québec City: 418-525-0337, ext. 4679
Toll-free: 1-877-525-0337, ext. 4679
E-mail: yvan.rabouin@lautorite.qc.ca