AUTORITÉ
DES MARCHÉS
FINANCIERS

Notice relating to the Application of International Financial Reporting Standards: 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* (the "AMF" or the "Authority") seeks to convey to institutions its guidance regarding the implementation of International Financial Reporting Standards (IFRSs). 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;
- accounting practices and capital adequacy requirements;
- adoption of IFRSs;
- transitional provisions;
- reporting requirements.

Unless indicated otherwise, the guidance contained in this Notice is based on IFRSs in effect as at March 31, 2010.

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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, Coopératives de services financiers* (Capital Adequacy Guidelines for Financial Services Cooperatives), December 2008. 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 IFRSs

The adoption of IFRSs results in the full retrospective application of all IFRS standards in effect at the end of an entity's first IFRS reporting date (i.e., December 31, 2011). Since the retrospective application of IFRSs may not always be practical, IFRS 1 - *First-time Adoption of International Financial Reporting Standards* was issued to provide some relief.

More specifically, the objective of IFRS 1 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.

The choices made by an institution as at the IFRS conversion date will impact the opening retained earnings, which will, in turn, have an impact on capital requirements. Unless indicated otherwise in this Notice, the impact of the application of IFRSs should be taken into account in the calculation of required capital.

4. 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, *Consolidated – Special Purpose Entities* will likely require them to report in their financial statements certain securitizations that would not have been reported under Canadian generally accepted accounting principles (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 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 insurers concerned to report their segregated fund assets and liabilities through a one-line reporting format. Given the current capital adequacy requirement to consider segregated fund risk, no additional requirement will apply to segregated fund assets and liabilities henceforth reported in the statement of financial position.

Securitization and Asset-to-Capital Multiple[3]

Considering that financial statements are the starting point for calculating the Asset-to-Capital Multiple (ACM), securitization assets that are not derecognized or exempted from consolidation must be included in the calculation of the ACM. The AMF expects the consolidation of these securitizations to have an impact on the ACM of the institutions concerned. The AMF has therefore provided for transitional provisions, set out hereunder.

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

Given the expected impacts on the ACM, the AMF will permit institutions concerned to exclude mortgages sold through the MBS/CMB Programs up to and including March 31, 2010 from the ACM calculation, where they are brought onto the statement of financial position under IFRSs. As a result, institutions will be required to exclude the effects of consolidation of mortgages sold under these programs up to and including March 31, 2010 from their statements of financial position used in the ACM calculation.

Moreover, to ensure that the result of the ACM calculation reflects the statement of financial position, MBS/CMB exposures occurring after March 31, 2010 should be included in the calculation of the ACM[4] if they are accounted for in the statement of financial position under IFRSs. However, irrespective of the IFRS determination of what is on the statement of financial position, the ACM should reflect the originator's post-securitization exposure. Where the securitization does not materially reduce the exposure of the originator's financial position,[5] continued inclusion in the ACM may be appropriate regardless of the accounting treatment.

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[3] The Asset-to-Capital Multiple (ACM) does not apply to damage and life and health insurers.

[4] Under the definition of Asset-to-Capital Multiple (ACM) in effect when IFRSs are adopted.

[5] As defined in the *Ligne directrice sur les normes relatives à la suffisance du capital de base, Coopératives de services financiers* (Capital Adequacy Guidelines for Financial Services Cooperatives), December 2008.

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 ACM calculation to give effect to the transitional provisions.

Developments in Basel standards

In view of the upheavals in the capital markets, the accounting treatment of securitization transactions under capital adequacy requirements[6] has undergone several changes following the release by the Basel Committee on Banking Supervision ("BCBS") of a consultative document covering this topic[7] in particular. The BCBS[8] is currently reviewing other measures that could have an impact on the accounting treatment for securitizations. Until the review findings are released (in 2011), and the measures possibly adjusted as a result, the AMF considers that the current provisions of the standard, which uses risk-based measures to calculate securitization exposure, remain relevant.[9]

- **Insurance contracts**

IFRS 4, *Insurance Contracts* is the first standard from the International Accounting Standards Board ("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. Therefore, institutions must apply the current version of the standard when adopting IFRSs.

Under GAAP, life and health insurers are required to 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 these insurers to continue to use CALM[10] to value insurance contract liabilities when adopting IFRSs.

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[6] Bank for International Settlements, *International Convergence of Capital Measurement and Capital Standards:* A *Revised Framework*, June 2006.

[7] Bank for International Settlements. *Enhancements to the Basel II framework,* July 2009.

[8] Bank for International Settlements, *Strengthening the resilience of the banking sector*, December 2009.

[9] *Autorité des marchés financiers*. *Ligne directrice sur les normes relatives à la suffisance du capital de base, Coopératives de services financiers* (Capital Adequacy Guidelines for Financial Services Cooperatives), December 2008.

[10] 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."

Financial instruments and service 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 IFRS.

Financial guarantee contracts

Financial guarantee contracts, as defined in Appendix A of IFRS 4, *Insurance Contracts*, may be recognized as insurance contracts under IFRS 4 or as financial instruments under IAS 39 *Financial Instruments – Recognition and Measurement.*

Insurers who elect to account for financial guarantee contracts as financial instruments should calculate capital adequacy requirements as though these contracts were accounted for as insurance contracts. The impact of this election must be reversed in the calculation of required and available capital.

Participating insurance

Under IFRS 4, life and health insurers may account for the guaranteed component separately from the discretionary participation feature. If an insurer elects to account for the guaranteed component and the discretionary participation feature separately, the guaranteed component must be classified as a liability. The discretionary participation feature can be classified as a liability or as a separate component of equity. The impact of this election should however be reversed in 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 henceforth reported on the statement of financial position.

- **Investment property**

IAS 40, *Investment Property* prescribes the treatment for recognizing and measuring property that meets the definition of 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 report unrealized gains and losses directly in the income statement.

The AMF allows 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 capital adequacy requirements.

- **Property, plant and equipment**

IAS 16, *Property, Plant and Equipment* sets out the treatment for the recognition of property, plant and equipment. IAS 16 applies in particular to property that does not meet the definition of investment property because a significant portion[11] is used by the owner. In accordance with this standard, property, plant and equipment must be recognized using the cost model or the revaluation model.

The AMF allows 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 routine operations. For life and health insurers, the value of property, plant and equipment determined using the moving average market method just prior to the transition to IFRSs may be used as cost for capital adequacy requirement purposes.

- **Financial instruments – Fair value option**

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

During 2010, the AMF intends to publish an amended version of the Notice that will reflect the implementation of IFRSs.

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[11] Paragraph 10 of IAS 40, *Investment Property*.

[12] The Notice was initially published in September 2006 and revised in November 2007 and December 2009, [(2009), Vol. 6, No. 50, AMF Bulletin, section 5.1].

5. Adoption of IFRSs

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 new standards, in respect of which the IASB would permit early adoption, will be published before the first IFRS financial statements are to be issued. The AMF does not permit early adoption of these standards at the time of publication. They will however be analyzed and the AMF will notify institutions when early adoption is permitted.

IFRS 9

In November 2009, the IASB published IFRS 9, *Financial Instruments*, on the classification and measurement of financial assets. The IASB permits early adoption of this standard, which applies to fiscal years beginning on or after January 1, 2013. Since IFRS 9 does not yet cover all aspects related to financial instruments, the AMF maintains its position of not permitting early adoption of this standard. The AMF will analyze the final standard when published and communicate its position to institutions.

6. Transitional provisions

Institutions may choose a transition period to defer the impact of the adoption of IFRS on the calculation of capital adequacy requirements. This election is irrevocable and must be made at the IFRS conversion date. Furthermore, institutions that choose this transition period must disclose this fact in their financial statements and mention the impact of this election on equity. The deferral period begins on the IFRS conversion date and must end on December 31, 2012.[13] The deferred amount will be amortized on a straight-line basis as of the IFRS conversion date.

Where an institution chooses a transition period, this decision will result in an adjustment to retained earnings reported in the calculation of capital adequacy requirements. The deferred amount will correspond to the difference between retained earnings for purposes of calculating equity determined the day prior to conversion to IFRSs in accordance with previous accounting standards and the retained earnings determined on the same date under IFRSs.

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[13] For institutions with a year-end other than December 31, the reporting period begins on the IFRS conversation date and ends on the date of their first statutory report to be filed with the AMF after December 31, 2012.

The amount covered by the transition period does not include the impact from the following:

- gains and losses on property, plant and equipment arising on transition;
- reversing entries for gains on sale of securitizations, other than mortgages sold under MBS/CMB Programs, in respect of which specific provisions apply (refer to section 4);
- shadow accounting;
- discretionary participation features reported as equity;
- financial guarantee contracts recognized as financial instruments.

7. Reporting requirements

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 ("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). Under IFRSs, institutions are not required to issue comparative financial statements before the conversion date.

Semi-annual progress report issued no later than July 31, 2010

To ensure that institutions provide a timely assessment of the impacts of the transition on opening equity, the AMF requires that they file a reconciliation of their equity at the date of transition along with 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 file this reconciliation with the AMF no later than July 31, 2010.

The reconciliation of equity must provide sufficient detail to enable the AMF to assess material adjustments to the statement of financial position. The AMF does not require this report to be audited.

First interim financial statements following conversion to IFRSs

The AMF requires institutions to furnish an equity reconciliation report when they file their first interim financial statements following conversion to IFRSs. The AMF does not require this reconciliation to be audited.

8. Other considerations – Damage (P&C) insurers

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 available capital and required capital from qualified subsidiaries, and will be modified to take into account insurer's consolidated reporting needs. The AMF is of the opinion that this change should not have a material impact on damage insurers' calculation of capital adequacy requirements.

Further information

Further information is available from:

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