

# Financial Instruments - Hedges

Section 3865

# Need for hedge accounting

- ◆ Mixed measurement and recognition models lead to timing differences
  - ◆ Cost or amortized cost vs. fair value
  - ◆ Other comprehensive income
  - ◆ Anticipated transactions

# Hedge accounting

- ◆ Existing requirements
  - ◆ Accounting Guideline 13, Hedging Relationships
  - ◆ Section 1650, Foreign Currency Translation
- ◆ International practice
  - ◆ FAS 133
  - ◆ IAS 39

# Qualifying for hedge accounting

- ◆ Designate a hedging relationship
  - ◆ Hedged item
  - ◆ Hedging item
- ◆ Document
- ◆ Ensure ongoing effectiveness

# Hedging relationships

- ◆ Designate
  - ◆ Hedged item
  - ◆ Hedging item
  - ◆ Cash instrument hedging items for FX only
  - ◆ Groups but NO macro-hedging
  - ◆ Limitations on internal hedges

# Hedged item

- ◆ **MUST BE**
  - ◆ a recognized asset or a recognized liability
  - ◆ an anticipated transaction, or
  - ◆ a net investment in self-sustaining foreign operation

# Hedged item

- ◆ Cannot be
  - ◆ an unrecognized intangible
  - ◆ a derivative, or
  - ◆ an investment in an equity instrument that is measured at cost because it has no quoted price in an active market

# Hedging items

- ◆ MUST BE
  - ◆ derivative (for any relationship) or
  - ◆ non-derivative financial asset or liability only for foreign currency risk

# Hedging items

- ◆ Cannot be
  - ◆ an equity-accounted investment
  - ◆ a non-derivative that is not a financial instrument, or
  - ◆ an anticipated transaction

# Hedge accounting

- ◆ Designate
  - ◆ Portions and hedged items
  - ◆ All risks or specified risks
  - ◆ Percentages and hedging items

# Hedge effectiveness

- ◆ Ineffectiveness may exist but hedge must expect overall high correlation of changes in fair values or cash flows
- ◆ Change in fair value is recorded in net income for:
  - ◆ Ineffective portion (deviation from 100% offset)
  - ◆ Excluded component (e.g. time value)

# Hedge accounting principles

- ◆ Modify not reduce risk
- ◆ Two perspectives of risk and exposure
  - ◆ Fair value
  - ◆ Cash flow

# Hedge accounting principles

- ◆ Two accounting models
  - ◆ Fair Value Hedge
  - ◆ Cash Flow Hedge
  - ◆ Hedge of Net Investment in Foreign Operations is a type of cash flow hedge

# Fair value hedge

- ◆ Hedge of the exposure to changes in the fair value of
  - ◆ a recognized asset or liability or
  - ◆ an unrecognized firm commitment
- ◆ Due to identified risk
- ◆ Possible net income effect

# Fair value hedge accounting

- ◆ Adjust the value of the hedged item for changes due to the hedged risk (mark to market)
- ◆ Recognize gain or loss from marking the hedged item in net income
- ◆ Gain/loss on hedging item to net income

# Fair value hedge

- ◆ Example 1
  - ◆ Issued fixed rate debt but want to benefit from an expected decline in interest rates
  - ◆ Hedge with a fixed/floating interest rate swap
- ◆ Considerations
  - ◆ Credit risk premium on debt

# Cash flow hedge

- ◆ Hedge of exposure to variability in cash flows associated with
  - ◆ a recognized asset or liability
  - ◆ a forecasted transaction or
  - ◆ a foreign currency risk in an unrecognized firm commitment
- ◆ Attributable to a particular risk
- ◆ Possible net income effect

# Cash flow hedge accounting

- ◆ No change to accounting for hedged item
- ◆ Effective portion of gain/loss on hedging item recognized initially in OCI
- ◆ OCI to net income as hedged item affects net income
- ◆ Permitted to adjust initial carrying amount of non-financial asset acquired
- ◆ Reclassify any net loss from OCI to net income if future recovery becomes doubtful

# Cash flow hedge accounting

## Example 2

- ◆ Anticipated purchase of equipment next year for US\$
- ◆ Use foreign exchange forward contract to hedge FX risk

# Cash flow hedge accounting

## Example 2

- ◆ Gains and losses on the forward to OCI
- ◆ Release to income as equipment is depreciated

# Hedge of net investment

- ◆ Hedge of exposure to exchange rate changes associated with net investment in a self-sustaining foreign operation
- ◆ Same treatment as a cash flow hedge

# Discontinue hedge accounting

- ◆ Hedging relationship fails to meet conditions in the Section
  - ◆ hedging item ceases to exist and is not replaced
  - ◆ hedged item ceases to exist
  - ◆ relationship no longer effective
- ◆ De-designation (elective)

# Disclosures

- ◆ Hedging objectives and strategies
- ◆ Effect of hedge accounting on financial statements
  - ◆ Disclose hedging items by type of hedge
  - ◆ Net income impact of ineffectiveness, excluded items and forecasted recycling from OCI
- ◆ Accounting policies

# Transition

- ◆ Mandatory first fiscal year beginning on or after October 1, 2006
- ◆ “Fresh start”
  - ◆ No retroactive restatement
  - ◆ Reallocate deferred gains and losses
  - ◆ Discontinue non-qualifying hedges

# Transition

- ◆ Implement concurrently with
  - ◆ Section 3855 – *Financial Instruments- Recognition and Measurement*
  - ◆ Section 1530 – *Comprehensive Income*
  - ◆ Numerous consequential amendments

# Implementation Guidance

- ◆ AcSB website: [www.acsbcanada.org](http://www.acsbcanada.org)
- ◆ Financial Instruments Working Group
- ◆ Contact Kate Ward at (416) 204-3437 or [kate.ward@cica.ca](mailto:kate.ward@cica.ca)

*Thank you*