

Financial Instruments – Hedges

Section 3865

Financial Instruments (slide 1)

This presentation provides an overview of Section 3865, Hedges, published by the Accounting Standards Board on January 27, 2005. Nothing in this presentation overrides the Section, which contains details not covered in the presentation.

In addition to the information in this presentation, you may find it useful to read the Board's rationale for publishing the standard and the requirements it contains which are included in its "Background Information and Basis for Conclusions" document. This document will be available during the second quarter of 2005.

The need for hedge accounting (slide 2)

We use a mixture of models to measure assets and liabilities and to recognize changes in their values in net income. Section 3855, Financial Instruments – Recognition and Measurement, will bring some consistency to these practices but will not eliminate the mix of models. Some financial assets and liabilities will continue to be recorded at cost or amortized cost with gains or losses only recognized on impairment, disposition or derecognition. On the other hand, Section 3855 requires many assets and some liabilities to be measured at fair value with the fair value changes on some of these assets recognized outside net income in other comprehensive income until disposition. Derivatives must be measured at fair value with changes in value recognized immediately in net income to ensure transparency. Finally, many anticipated transactions create exposures to variable future cash flows but are not recognized until a contractual right or commitment exists. Accordingly, there are many opportunities for the timing of income recognition to differ between financial instruments with offsetting economic characteristics. Hedge accounting is an optional mechanism to compensate for these differences.

Hedge accounting (slide 3)

Accounting Guideline AcG-13, *Hedging Relationships*, currently prescribes the circumstances under which hedge accounting is acceptable as well as when to discontinue it. However, this Guideline does not address how hedge accounting is to be performed. Section 1650, *Foreign Currency Translation*, provides guidance for hedge accounting for foreign currency hedges but this guidance is out of date and inconsistent with current best international practice.

Section 3865 will allow Canadians to comply with both US GAAP, as set out in Statement of Financial Accounting Standards, FAS 133, and International Financial Reporting Standards, as set out in International Accounting Standard IAS 39.

Qualifying for hedge accounting (slide 4)

The requirements for establishing hedge accounting carry forward from AcG-13:

- You must designate a hedging relationship between a hedged item and a hedging item.
- You must document the risk management objective and strategy and the specific risk exposure or exposures the hedging relationship is expected to address. You must also document how you will measure the effectiveness of the relationship and its expected term.
- Finally, you must ensure that the relationship remains effective throughout its duration.

Hedging relationships (slide 5)

Section 3865 has clarified the components of qualifying hedging relationships. Changes to the definition of “hedged item” were made for consistency with both US GAAP and IFRS.

Section 3865 specifies that an anticipated transaction cannot be designated as a hedging item. However, the most significant change to the definition of hedging item is to discontinue the use of cash instruments such as bonds as hedging items other than in hedges of foreign currency risk.

A hedging relationship may be formed with a group of similar assets or similar liabilities as either the hedged item or hedging item or a group of similar anticipated transactions as the hedged item. However, a net position of similar assets and liabilities may not be designated in a hedging relationship. This is because it is impossible to determine when the net position settles and the hedge relationship ends.

Most intercompany hedging transactions eliminate on consolidation so the circumstances under which internal hedges qualify have been restricted to certain foreign currency hedges involving anticipated transactions.

Hedged item (slide 6)

The definition of “hedged item” in Section 3865 is consistent with International Accounting Standard IAS 39. FAS 133 does not use the term but Section 3865 is consistent with FAS 133 in this regard. A hedged item must be a recognized asset or a recognized liability, an anticipated transaction or a net investment in a self-sustaining foreign operation.

Hedged item (slide 7)

Implicit in the definition of “hedged item” are restrictions on hedging unrecognized assets or liabilities other than anticipated transactions. Hedging freestanding or

bifurcated derivatives is explicitly prohibited because they are already measured at fair value. The risk presented by a derivative that is embedded in a hybrid instrument but is not required to be separated from the host in accordance with Section 3855 may be designated as the hedged item. Section 3865 explicitly prohibits designating an investment in an equity instrument that is measured at cost because fair value cannot be reliably measured.

Hedging items (slide 8)

In most cases, only a derivative or group of similar derivatives may be designated as the hedging item in a hedging relationship. Section 3865 also allows the designation of a cash instrument, that is, a non-derivative financial asset or liability, only as the hedging instrument in a hedge of foreign currency risk.

Hedging items (slide 9)

Hedging items cannot be equity-accounted investments because the equity method of accounting is inconsistent with fair value measurement. Implicit in the definition of “hedging item” are prohibitions on designating non-financial assets or liabilities and anticipated transactions as hedging items.

Hedge accounting (slide 10)

It is not necessary to designate the entire hedged item for hedge accounting to apply. It is possible to designate a percentage of the item, specific cash flows or a percentage of specific cash flows. It is also possible to designate an embedded derivative that is not bifurcated from the host contract in accordance with Section 3855. By being very specific about the risk exposures the hedging relationship is designed to offset, you can minimize problems with ineffectiveness during the term of the relationship.

In contrast, hedging items may be designated only in whole or as a percentage of the whole. However, it is possible to exclude the time value and/or volatility values of option contract hedging items and the time value of forward contract hedging items. This feature can also be useful in preventing hedge failure due to ineffectiveness.

Hedge effectiveness (slide 11)

Hedge accounting results in changing the normal accounting treatment of at least one of the components of the hedging relationship. To prevent abuse, it is important that qualifying conditions be met at inception and throughout the term of the relationship. The most important condition is that the relationship be effective in achieving offsetting fair values for a fair value hedge, or offsetting future cash flows for a cash flow hedge. A perfect offset is not required at all times, however, high correlation is expected. Hedge accounting must be discontinued if ineffectiveness becomes excessive.

Ineffectiveness within tolerable limits is recognized immediately in net income.

Gains and losses arising from any aspect of a hedging item that is excluded from the hedge designation, such as time values as previously noted, are also recognized immediately in net income.

Hedge accounting principles (slide 12)

It is important to note that hedge accounting requires a modification of risk, not risk reduction. There are two ways of looking at risk – an exposure can either affect the fair value of an asset or liability or it can cause variability in future cash flows. Accordingly, there are two hedge accounting models to address these two perspectives.

Hedge accounting principles (slide 13)

Fair value hedge accounting addresses hedging relationships designed to offset changes in the fair value of a recognized asset or liability or unrecognized firm commitment.

Cash flow hedge accounting addresses relationships intended to offset potential variability in future cash flows. The hedge of a net investment in a self-sustaining foreign operation is a type of cash flow hedge.

Fair value hedge (slide 14)

A fair value hedge is a hedge of an exposure to changes in the fair value of a recognized asset or liability or unrecognized firm commitment that is attributable to a particular risk and that could affect net income. Fair value hedges are useful tools for managing risks associated with assets and liabilities that are recorded at cost or amortized cost. Because you are assumed to be achieving your interest rate expectations when you classify a financial asset as held-to-maturity, you may not designate a held-to-maturity financial asset as a hedged item for interest rate risk. However, you may designate it for foreign currency, credit and/or prepayment risk.

Fair value hedge accounting (slide 15)

Fair value hedge accounting requires that the hedged item be marked to market for changes in fair value due to the hedged risk. Gains or losses on the hedged item are recognized in current period net income. It is important to note that it is only the designated risk factor that is used to adjust the fair value of the hedged item. This might necessitate using a mathematical model to isolate the effect of the specified risk. However, the additional precision might be necessary to prevent ineffectiveness. The hedging item is also marked to market with changes in fair value recognized in net income.

Fair value hedge (slide 16)

In this first example, assume that you have issued fixed rate debt but want to benefit from an expected decline in interest rates. You enter into a receive-fixed, pay-floating interest

rate swap. Because the value of a fixed rate debt instrument varies with changes in interest rates, you can designate a fair value hedge. The swap will enable you to participate in fluctuations in interest rates. Without hedge accounting, changes in the fair value of the derivative, the swap in this case, will be reflected in each period's net income while the cost of the debt is recognized in net income using the effective interest rate method. Assuming the principal amount of the debt equals the notional amount of the swap and the maturities match, over the life of the two instruments, net income will be equal to the floating leg payments on the swap plus or minus any differential between the fixed leg of the swap and the rate on the debt. However, changes in market rates will create variability in net income over the life of the swap. Hedge accounting will allow you to avoid this variability.

In designating this relationship for hedge accounting purposes, you need to be sensitive to any basis risk created by a credit risk premium on the debt instrument. It may be appropriate to designate the underlying base rate to avoid potential ineffectiveness.

Cash flow hedge (slide 17)

If, on the other hand, you issued floating rate debt but are concerned with the variability of your cash flows, you might enter into a receive-floating, pay-fixed interest rate swap. In this situation, you will designate a cash flow hedge as opposed to a fair value hedge because the value of floating rate debt does not vary significantly with changes in market interest rates.

A cash flow hedge is a hedge of the exposure to variability in cash flows associated with:

- a recognized asset or liability (such as all or a specified portion of future interest payments on variable rate debt);
- a forecasted transaction (such as a forecasted purchase or sale); or
- a foreign currency risk in an unrecognized firm commitment;

that is attributable to a particular risk and could affect reported net income

Cash flow hedge accounting (slide 18)

Cash flow hedge accounting does not violate the principle that derivatives must be measured at fair value. However, to achieve the effect of recognizing gains and losses on the hedging item at the same time as the hedged item affects net income, the effective portion of the gains and losses on the hedging item are held temporarily in Other Comprehensive Income (OCI) and subsequently released to net income at the same time as the hedged item affects net income.

When the future transaction that is hedged is the acquisition of an item for which gains and losses are not immediately recognized in net income, the gains and losses on the hedging item included in other comprehensive income are released to net income only over the period of time that the gains and losses on the asset affect net income. An example is the acquisition of a fixed asset which affects income as it is depreciated over

its useful life. In this case, the gains and losses on the hedging item are released to net income over the period that the asset is depreciated.

Section 3865 permits you to adjust the initial carrying amount of a non-financial asset acquired or a non-financial liability assumed by the balance in OCI related to the hedge. This can simplify the bookkeeping for the amortization of the OCI balance. However, this would create a US GAAP difference.

You are also required to reclassify any net loss from OCI to net income if future recovery becomes doubtful.

Cash flow hedge accounting (slide 19)

In this second example, assume you are planning to purchase a machine next year and the price will be in US dollars. You might enter into a foreign exchange forward contract to lock in a rate for your purchase of the US currency needed to complete your acquisition. These transactions could be designated as a cash flow hedging relationship.

Cash flow hedge accounting (slide 20)

The effective portion of the gains and losses on the forward contract will be recognized in OCI. Any ineffective portion will be recognized in net income immediately. As the machine is depreciated, the balance in OCI will be amortized to net income, either directly from OCI or as a component of the carrying amount of the asset.

Hedge of net investment (slide 21)

Section 3865 defines a third type of hedge as a hedge of a net investment in a self-sustaining foreign operation.

This is accounted for in the same manner as a cash flow hedge, with gains and losses on the hedging item recognized in other comprehensive income until such time as the gains and losses on translating the foreign investment are included in net income – i.e., when there is a reduction in the net investment.

Discontinue hedge accounting (slide 22)

You must discontinue hedge accounting when a hedging relationship ceases to satisfy the conditions for hedge accounting specified in Section 3865. This occurs when:

- (a) the hedging item ceases to exist as a result of its maturity, expiry, sale, termination, cancellation or exercise, unless it is replaced by another hedging item as part of the entity's documented hedging strategy;
- (b) the hedged item ceases to exist as a result of its maturity, expiry, sale, termination, cancellation or exercise;
- (c) the hedged item is an anticipated transaction and it is no longer probable that it will occur within two months of the designated date; or

(d) the hedging relationship ceases to be effective.

In the case of a mandatory discontinuance of hedge accounting you do not reverse the accounting balances recorded while the hedge was in place. The balance in other comprehensive income relating to the hedge generally tracks the disposition of the hedged item. In other words, if the hedge is discontinued because the hedged item ceases to exist, the balance in OCI is reclassified to net income. When the hedged item continues to exist, the balance remains in OCI to be reclassified to net income when the hedged item impacts net income.

You may also elect to de-designate a hedge at any time, however, you do not reverse any accounting entries made prior to the date of de-designation and any balance in OCI tracks the treatment of the hedged item.

Disclosures (slide 23)

Since hedge accounting is optional and results in exceptional treatment of certain financial statement items, it is important that readers of the financial statements be able to discern why hedge accounting has been used and what its impact is. You are required to disclose your risk management objectives and strategies and how your hedging activities achieve those objectives. This disclosure does not extend to commercially sensitive or proprietary information but is intended to put the financial statement information in context. You must disclose the types of hedges used and a breakdown of hedging instruments employed. You must also provide information about ineffectiveness and amounts to be reclassified from OCI to net income in the next twelve months.

You must disclose your accounting policy for hedging relationships and your policy for gains and losses on anticipated transaction cash flow hedges of non-financial assets and liabilities.

Transition (slide 24)

The financial instrument standards may be implemented as at the beginning of any fiscal year for which statements have not already been issued but must be implemented no later than the beginning of the first fiscal year beginning on or after October 1, 2006. For many entities, this will be the 2007 fiscal year.

You do not restate the financial statements for prior years. If you had previously applied hedge accounting and wish to continue, you re-assess your existing hedging relationships against the criteria in Section 3865. Any hedges that fail to qualify must be discontinued. All balances are adjusted in accordance with the requirements of Section 3865 with any remaining amounts transferred to the opening balance of retained earnings or OCI, as applicable.

Transition (slide 25)

Section 3865 must be implemented at the same time as Sections 3855, Financial Instruments – Recognition and Measurement, and 1530, Comprehensive Income. There are also numerous amendments to other sections necessitated by the introduction of these standards.

Implementation Guidance (slide 26)

As guidance becomes available, it will be posted on the AcSB's website located at www.acsbcanada.org.

A Financial Instruments Working Group has been formed to develop implementation guidance for all of the financial instruments standards. Please contact Kate Ward at (416) 204-3437 or kate.ward@cica.ca with any questions you would like to see addressed by this group.