ASPE AT A GLANCE

Section 3856 - Financial Instruments

February 2022

Section 3856 – *Financial Instruments*

Effective Date
Fiscal years beginning on or after January 1, 2011[1]

SCOPE

Applies to all financial instruments except for the following:

- Interests in subsidiaries, entities subject to significant influence, and joint arrangements that are accounted for in accordance with Section 1591, *Subsidiaries*, Section 3051, *Investments*, and Section 3056, *Interests in Joint Arrangements*; however, this Section does apply to a derivative that is based on such an interest.
- Leases (see Section 3065, *Leases*), although Appendix B of this Section applies to transfers of lease receivables.
- Employer's rights and obligations for employee future benefits and related plan assets (see Section 3462, *Employee Future Benefits*).
- Insurance contracts, including the cash surrender value of a life insurance policy.
- Investments held by an investment company that are accounted for at fair value in accordance with AcG-18, *Investment Companies*; however, the disclosure requirements in paragraphs 3856.37-.54 apply to an investment company.
- Contracts and obligations for stock-based compensation to employees and stock-based payments to non-employees (see Section 3870, *Stock-based Compensation and Other Stock-based Payments*).
- Guarantees, other than guarantees that replace financial liabilities as described in paragraph 3856.A58 (see also AcG-14, *Disclosure of Guarantees*).
- Contracts based on revenues of a party to the contract.
- Loan commitments (see Section 3280, *Contractual Obligations*, and Section 3290, *Contingencies*).
- Contractual arrangements that prevent sale treatment (for example, an option to repurchase transferred receivables).
- Contracts issued by an acquirer (but not the seller) for contingent consideration in a business combination until such time as the contingency is resolved (see Section 1582, *Business* Combinations, paragraphs .41-.42). This exception applies only to the acquirer (the entity that is accounting for the combination) and not to the seller.

Does not apply to:

- Contracts to buy or sell non-financial items except for:
  - Exchange-traded futures contracts; and
  - Contracts that are designated in a qualifying hedging relationship in accordance with paragraphs 3856.30-.36.
- Non-financial assets and non-financial liabilities

Not-for-profit organizations do not apply some aspects of Section 3856, as outlined in the publication below[2].

COMMON FINANCIAL INSTRUMENTS

- Cash;
- Demand and fixed-term deposits;
- Commercial paper, bankers' acceptances, treasury notes and bills;
- Accounts, notes and loans receivable and payable;
- Bonds and similar debt instruments, both issued and held as investments;
- Common and preferred shares and similar equity instruments, both issued and held as investments; and
- Options, warrants, futures contracts, forward contracts, and swaps.

DEFINITIONS

FINANCIAL INSTRUMENT

A contract that creates a financial asset for one entity and a financial liability or equity instrument of another entity.

RELATED PARTY FINANCIAL INSTRUMENT

A contract between related parties[3] that creates a financial asset for one entity and a financial liability or equity instrument of another entity.

FINANCIAL ASSET

Any asset that is:

- Cash;
- A contractual right to receive cash or another financial asset from another party;
- A contractual right to exchange financial instruments with another party under conditions that are potentially favourable; or
- An equity instrument of another entity.

The cost incurred by an entity to purchase a right to reacquire its own equity instruments from another party is a deduction from its equity, not a financial asset.

FINANCIAL LIABILITY

Any liability that is a contractual obligation:

- To deliver cash or another financial asset to another party; or
- To exchange financial instruments with another party under conditions that are potentially unfavourable to the entity.

EQUITY INSTRUMENT

Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

DERIVATIVE

A contract with all three of the following characteristics:

- It's value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or other variable (sometimes called the "underlying"), provided in the case of a non-financial variable that the variable is not specific to a party to the contract;
- It requires no initial investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- It is settled at a future date.

FAIR VALUE

The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act (refer to paragraph 3856.A7 for additional guidance).

CARRYING AMOUNT

For the purposes of applying paragraph 3856.08B, carrying amount is the amount of an item transferred, or cost of services provided, as recorded in the accounts of the transferor, after adjustment, if any, for amortization or impairment in value.

EXCHANGE AMOUNT

The amount of consideration paid or received as established and agreed to by related parties.

[1] Except as specified in paragraph 3856.55.
[2] Not-for-profit organizations do not apply paragraphs 3856.19AA, 28A, .42A, 47A, A37A-.A37A and .A60A
[3] Refer to our ASPE at a Glances publications on Section 3840, *Related Party Transactions*, and Section 4460, *Disclosure of Related Party Transactions by Not-for-Profit Organizations*, for further guidance on the definition of related parties.

RECOGNITION

Financial instruments are recognized on the Balance Sheet when the entity becomes party to the contractual provisions of the instrument.

MEASUREMENT

INITIAL MEASUREMENT [4, 5]

ARM'S LENGTH TRANSACTION

- Except for retractable or mandatorily redeemable shares issued in a tax planning arrangement (RoMRS), which are discussed later in this publication, all financial assets originated or acquired and all financial liabilities issued or assumed in arm's length transactions are measured initially at fair value[6].
- Directly attributable transaction costs are added to or deducted from the fair value of those financial instruments that are not measured subsequently at fair value.
  - **Directly attributable transaction costs** - incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (Transaction costs include expenditures such as legal fees, reimbursement of the lender's administrative costs and appraisal costs associated with a loan. Transaction costs do not include financing fees, debt premiums or discounts).
- If there is a difference between the consideration paid or received and the fair value of the instrument, the difference should be recognized in net income unless it qualifies as some other type of asset or liability.

RELATED PARTY TRANSACTION[7]

COST

Except as noted in paragraphs 3856.08C and 08D (explained in the boxes to the right) and for RoMRS, when a financial asset is originated or acquired or a financial liability is issued or assumed in a related party transaction, it is initially measured at cost. Cost is dependent on whether the instrument has repayment terms. When the instrument:

- Has repayment terms (refer to paragraph 3856.A8A for examples), its cost is determined using the undiscounted cash flow(s), excluding interest and dividend payments, of the instrument less any impairment losses previously recognized by the transferor;
- Does not have repayment terms (refer to paragraph 3856.A8B for examples), its cost is determined using the consideration transferred or received by the entity. When the consideration transferred by the entity:
  - Is a financial instrument with repayment terms, the undiscounted cash flow(s), excluding interest and dividend payments, of the instrument transferred as consideration less any impairment losses previously recognized by the transferor is used as cost;
  - Is an asset or liability without repayment terms, the carrying or exchange amount of the consideration transferred is used as cost:
    - The cost of the instrument is the exchange amount of the consideration transferred or received when:
      - The transaction is in the normal course of operations; or
      - The transaction is not in the normal course of operations and
        - The transaction is a monetary transaction or a non-monetary transaction that has commercial substance;
        - The change in the ownership interest in the related financial item transferred is substantive; and
        - The amount of consideration paid or received is established and agreed to by related parties and is supported by independent evidence.
    - Otherwise, the cost of the instrument is the carrying amount of the consideration transferred or received.

FAIR VALUE

As per paragraph 3856.08C, the following financial instruments originated or acquired in a related party transaction are measured at fair value without any adjustments:

- Investments in equity instruments or debt instruments quoted in an active market;
- Debt instruments when the inputs significant to the determination of fair value are observable, either directly or indirectly; and
- Derivative contracts.

VARIABLE PORTION

As per paragraph 3856.08D, except for related party indexed liabilities to which paragraph 3856.14A applies, an entity does not measure the variable or contingent portion of a related party financial instrument.

Instead, the terms of the instrument are disclosed and the instrument is remeasured at fair value once the contingency or variability is resolved, with any gain or loss recognized in net income.

GAIN OR LOSS

Except for RoMRS, on initial measurement, when a related party transaction includes a financial instrument that is in the normal course of operations, or is not in the normal course of operations and:

- The transaction is a monetary or non-monetary transaction that has commercial substance;
- The change in the ownership interests in the items transferred is substantive; and
- The transaction amounts for each of the elements in the transaction are supported by independent evidence,

In that situation, any gain or loss resulting from initial recognition is included in net income, unless another Section requires alternative treatment. Otherwise, any difference resulting from the transaction is included in equity.

INDEXED LIABILITIES

The issuer of a financial liability that is indexed to a measure of the entity's financial performance or to changes in the value of the entity's equity, initially measures the instrument in accordance with the requirements for arm's length transactions or related party transactions, which are outlined in the boxes to the left.

[4] Except as specified in this section, transaction costs are recognized in net income in the period incurred.
[5] Refer to paragraph 3856.A7A for a summary chart that illustrates initial measurement of various financial instruments.
[6] Applies to parties whose sole relationship with an entity is in the capacity of management (see paragraph 3856.07A).
[7] Refer to paragraph 3856.A8K for a decision tree that outlines initial measurement of financial instruments in a related party transaction.

SUBSEQUENT MEASUREMENT[8]

COST/AMORTIZED COST

- If the financial instrument was initially measured at cost, it is subsequently measured using the cost method less any reduction for impairment.
- Investments in equity instruments not quoted in an active market, when originated or acquired in an arm's length transaction, are measured at cost less any reduction for impairment.
- All other financial assets and liabilities are measured at amortized cost, except for those noted in the boxes to the right.
  - When determining amortized cost either the effective interest rate or straight line methods may be used to recognize the premium or discount and all related transactions costs and financing fees over the expected life of the instrument with limited exceptions.

FAIR VALUE

The following financial instruments should be subsequently measured at fair value without any adjustment for transaction costs the entity may incur on sale/disposal:

- Investments in equity instruments that are quoted in an active market.
- Derivative contracts, except for derivatives that are designated in a qualifying hedging relationship or derivatives that are linked to, and must be settled by delivery of, equity instruments of another entity whose fair value cannot be readily determined.

Changes in fair value are recognized in net income.

When an investments in an equity instrument of a related party ceases to be quoted in an active market, its fair value immediately before it ceases to be quoted becomes its cost, and it is subsequently measured using the cost method.

Except for RoMRS, an entity may elect to subsequently measure any financial asset originated or acquired or financial liability issued or assumed in an arm's length transaction, at fair value by irrevocably designating the financial instrument to be measured at fair value when:

- The asset or liability is initially recognized; or
- The equity instrument ceases to be quoted in an active market.

An entity may elect to subsequently measure any debt instruments originated or acquired or issued or assumed in a related party transaction, at fair value by irrevocably designating the instrument to be measured at fair value when the instrument is initially recognized and:

- The debt instruments is quoted in an active market; or
- The inputs significant to the determination of the fair value of the debt instrument are observable, either directly or indirectly.

When the above debt instruments cease to be quoted in an active market and/or the inputs significant to the determination of fair value are no longer observable, the instruments fair value immediately before this occurs becomes its cost, and it is subsequently measured at amortized cost.

INDEXED LIABILITIES

The issuer of a financial liability that is indexed to a measure of the entity's financial performance or to changes in the value of the entity's equity, subsequently measures the liability at each reporting date:

- For an arm's length financial liability, by adjusting the carrying amount of the liability to the higher of:
  - The amortized cost of the debt[9]; and
  - The amount that would be due at the balance sheet date if the formula determining the additional amount was applied at that date.
- For a related party financial liability, by adjusting the carrying amount of the liability to the higher of:
  - The cost of the debt; and
  - The amount that would be due at the balance sheet date if the formula determining the additional amount was applied at that date.

Adjustments are recognized in net income and presented as a separate component of interest expense.

IMPAIRMENT

At the end of each reporting period, an entity must assess whether there are any indicators that a financial asset or group of similar financial assets, measured at cost, amortized cost or using the cost method may be impaired.

- An indicator of impairment is a condition or event that will cause a significant adverse change in the expected timing or amount of future cash flows such as significant financial difficulty of the issuer or customer or significant adverse changes in technological, market, economic or legal environment in which the issuer/customer operates in (refer to paragraphs .A15-.A16 for additional indicators of impairment).

MEASUREMENT

Except as specified below for related party debt or equity instruments, if there is evidence of impairment, an entity reduces the carrying amount of the asset, or group of assets, to the highest of the following:

a) The present value of the cash flows from holding the asset / group of assets discounted using an appropriate current market rate of interest;

b) The amount that could be realized by selling the asset / or group of assets at the balance sheet date; and

c) The net amount the entity expects to realize by exercising its right to any collateral held to secure repayment of the asset / group of assets.

The carrying amount of the asset / group of assets is reduced directly or through the use of an allowance account through net income.

For debt instruments originated or acquired in a related party transaction and initially measured at cost, an entity reduces the carrying amount of the asset / group of similar assets to the highest of, the undiscounted cash flows expected to be generated by holding the asset(s) (excluding interest and dividend payments) and the amounts specified in sub-paragraphs (b) and (c) above.

For equity instruments originated or acquired in a related party transaction and initially measured at cost, an entity reduces the carrying amount of the asset / group of similar assets to the amount that could be realized by selling the asset(s) at the balance sheet date.

An impairment previously recognized, can be reversed through net income if the situation changes in the future. However, the adjusted carrying amount of the asset/ group of similar assets cannot be greater than the amount that would have been reported at the date of the reversal had the impairment not been recognized previously.

[8] Refer to paragraph 3856.A13A for a summary chart that illustrates subsequent measurement of various financial instruments.

[9] Interest expense is calculated using the stated interest rate, plus or minus the amortization of any initial premium or discount.

FORGIVENESS

After assessing for and recognizing any impairment, forgiveness of all or part of a related party financial assets* is recognized in:

- Equity, when the transaction that resulted in the origination or acquisition of the financial asset was not in the normal course of operations; or
- Net income when:
  - The transaction that resulted in the origination or acquisition of the financial asset was in the normal course of operations; or
  - It is impracticable to determine whether the forgiven related party financial asset was originated or acquired in the normal or not in the normal course of operations.

*Not for profit organizations must recognize the forgiveness of a related party financial asset in the Statement of Operations.

PRESENTATION

INVESTMENTS

Income from investments subsequently measured at fair value or cost or using the cost method must be presented separately on the face of the Income Statement.

LIABILITY OR EQUITY

- Except for RoMRS, a financial instrument, or its components, is classified by the issuer as a liability or as equity in accordance with the substance of the contractual arrangement on initial recognition and not based on its legal form.
- A financial liability exists when:
  - The issuer has a contractual obligation to deliver cash or another financial asset to the holder or to exchange another financial instrument with the holder under conditions that are potentially unfavourable to the issuer. A restriction on the ability of the issuer to satisfy an obligation does not negate the issuer's obligation or the holder's right under the instrument; or
  - An issuer's obligation can be settled through the issuance of shares and the number of shares fluctuates in response to changes in a variable other than the market price of the entity's own equity instruments.

ARM'S LENGTH TRANSACTIONS

In an arm's length transaction, if an instrument has both liability and equity components, such as is the case with convertible debt or when warrants or options are issued with and detachable from a liability, an accounting policy choice exists as there are two acceptable methods for measurement of the liability and equity elements on initial measurement:

- The equity component is measured at zero. As a result, the entire proceeds are allocated to the liability component; or
- The less easily measurable component is allocated to the residual amount after deducting from the entire proceeds of the issue the amount separately determined for the component that is more easily measurable.

RELATED PARTY TRANSACTIONS

Similarly, in a related party transaction, if an instrument has both liability and equity components, an accounting policy choice exists as there are two acceptable methods for measurement of the liability and equity elements on initial measurement:

- The equity component is measured at zero. As a result, the entire proceeds are allocated to the liability component; or
- The equity component is allocated the residual amount after deducting from the entire proceeds of the issue the amount separately determined for the liability component measured in accordance with paragraph 3856.08(a).

EXCEPTIONS[10]

The following instruments are classified as equity on initial recognition:

- Partnership interests and certain types of shares in co-operative organizations that provide for payments to the holder of a pro rata share of the residual equity of the issuer in the event of specific events like liquidation or death of the holder.

A retractable or mandatorily redeemable share, other than RoMRS, is classified as a liability unless all of the following criteria are met:

- The redeemable shares are the most subordinated of all equity instruments issued by the enterprise;
- The redemption feature is extended to 100 percent of the common shares and the basis for determination of the redemption price is the same for all shares;
- The shares have no preferential rights relative to other classes of shares of the enterprise that have the same degree of subordination; and
- The redemption event is the same for all the shares subject to the redemption feature.

[10] Refer to paragraph 3856.A29 for a helpful decision tree the outlines classification of retractable or mandatorily redeemable shares.

LIABILITY OR EQUITY (CONTINUED)

RETRACTABLE OR MANDATORILY REDEEMABLE SHARES ISSUED IN A TAX PLANNING ARRANGEMENT (RoMRS)

INITIAL CLASSIFICATION

- Per paragraph 3856.23, when an entity issues retractable or mandatorily redeemable shares in a tax planning arrangement[11] (RoMRS), it may choose to present those shares at par, stated or assigned value as a separate line item in the **equity** section of the Balance Sheet <u>only</u> when **<u>ALL</u>** of the following conditions are met:
  - Control (refer to Section 1591, *Subsidiaries*, for guidance on determining control) of the entity issuing the RoMRS is retained by the individual shareholder[12] receiving the shares in the arrangement;
    - If an entity issues RoMRS to two or more related parties, an assessment of which related party, if any, controls the entity (control assessment is performed in accordance with Section 1591) is needed to determine whether control of the entity is retained by the shareholder receiving the shares in the arrangement.
  - In the arrangement, either:
    - No consideration is received by the entity issuing the RoMRS; or
    - Only shares of the entity issuing the RoMRS are exchanged; and
  - No other written or oral arrangement (such as a redemption schedule) exists, that gives the holder of the shares the contractual right to require the entity to redeem the shares on a fixed or determinable date or within a fixed or determinable period.

  If any of the above conditions are <u>not met</u> for any or all of the shares issued, the issuer must classify those shares as a **financial liability**, present them separately on the Balance Sheet and measure them at their redemption amount. Any resulting adjustment is recognized in either retained earnings or a separate component of equity.

- An entity can choose to initially present RoMRS as a financial liability, even if the criteria for equity classification outlined above are met. However, once RoMRS have been classified as a financial lability they <u>cannot</u> subsequently be reclassified as equity.

SUBSEQUENT CLASSIFICATION

- RoMRS initially classified as equity, are not subsequently reclassified to liability unless an event or transaction occurs that indicates the conditions for equity classification are no longer met. Examples of indicators that equity classification may no longer be met include, but are not restricted to:
  - The death of the holder of the RoMRS;
  - A change in ownership of the entity that may affect the assessment of control of the entity that issued the RoMRS;
  - A change in the shareholders' agreement that may affect the assessment of control of the entity that issued the RoMRS;
  - Redemption of some or all of the RoMRS;
  - The creation of a written or oral arrangement that gives the holder of the RoMRS the right to require the entity to redeem the shares within a fixed or determinable period; or
  - Modifications to the RoMRS.
- When an event or transaction gives rise to a reclassification of RoMRS from equity to a financial liability, the entity measures the reclassified shares at the redemption amount on that date and presents them separately on the Balance Sheet. Any resulting adjustment is recorded in retained earnings or a separate component of equity in accordance with Section 3251, *Equity*.
- Once RoMRS have been classified as a financial lability they <u>cannot</u> subsequently be reclassified as equity.
- RoMRS classified as a financial liability are <u>not</u> permitted to use the callable debt presentation outlined in the illustrative example in Section 1510, *Current Assets and Current Liabilities*.

OFFSETTING

A financial asset and a financial liability can only be offset, and the net amount reported on the Balance Sheet, when an entity:
- Currently has a legally enforceable right to set-off the recognized amounts; and
- Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

[11] If an entity issues RoMRS through a series of transactions in contemplation of one another, the transactions are viewed as one tax planning arrangement when assessing the conditions in paragraph 3856.23.
[12] Refer to the example in paragraph 3856.23C.

DERECOGNITION

FINANCIAL ASSETS

Receivables are derecognized only when the transferor has surrendered control. Control is surrendered when all of the following conditions are met:

- The transferred assets have been isolated from the transferor — put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership;
- Each transferee has the right to pledge or exchange the assets it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor; and
- The transferor does not maintain effective control over the transferred assets through either:
  - An agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity; or
  - The ability to unilaterally cause the holder to return specific assets with limited exception.

Upon completion of a transfer of receivables that satisfies the conditions to be accounted for as a sale, the transferor (seller):

- Derecognizes all assets sold;
- Recognizes all assets obtained and liabilities incurred in consideration as proceeds of the sale;
- Initially measures at fair value assets obtained and liabilities incurred in a sale; and
- Recognizes in income any gain or loss on the sale.

The transferee recognizes all assets obtained and any liabilities incurred and initially measures them at fair value (in aggregate, presumptively the price paid).

Servicing is inherent in all receivables; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. A servicer that recognizes a servicing asset or servicing liability accounts for the contract to service receivables separately from those assets, as follows:

- Report servicing assets separately from servicing liabilities in the Balance Sheet.
- Initially measure servicing assets retained in a securitization of the assets being serviced at their allocated previous carrying amount based on relative fair values, if practicable, at the date of the securitization.
- Initially measure servicing assets purchased or servicing liabilities assumed at fair value.
- Initially measure servicing liabilities undertaken in a securitization at fair value, if practicable.
- Account separately for rights to future interest income from the serviced assets that exceed contractually specified servicing fees.
- Subsequently measure servicing assets by amortizing the amount recognized in proportion to and over the period of estimated net servicing income — the excess of servicing revenues over servicing costs.
- Subsequently evaluate and measure impairment of servicing assets.
- Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss — the excess of servicing costs over servicing revenues.

FINANCIAL LIABILITIES

A financial liability (or part of it) is extinguished when the debtor:

- Discharges the liability (or part of it) by paying the creditor; or
- Is legally released from primary responsibility for the liability (or part of it), either by process of law or by the creditor.

As a result, payments to third parties, including a trust (i.e. in-substance defeasance), by itself will not result in derecognition of the liability, without legal release from the creditor.

Except as specified in paragraph 3856.29A[12], in an arm's length transaction, when the terms of a financial liability are changed:

- An entity must determine whether the change is substantial and as such should be accounted for as an extinguishment of old debt and recognition of new debt, or whether the change is a modification of debt.
- Extinguishment accounting will be applied when the change in terms is substantial. The change is considered substantial when:
  - The present value of the cash flows under the new terms differs by at least 10% from the present value of the remaining cash flows under the original terms, both discounted at the original rate of interest; or
  - There is a change in the creditor and the original debt is legally discharged by the debtor through a cash payment or otherwise.
- The difference between the carrying amount of the financial liability extinguished and the fair value of the consideration paid, is recognized in net income for the period.

A transaction between related parties to replace all or part of a debt instrument with another instrument or to modify the terms of the existing financial liability:

- Must be accounted for as an extinguishment of the original financial liability and the recognition of a new financial instrument.
- The difference between the carrying amount of a financial liability extinguished or transferred to another related party and the amount of consideration paid is recognized in*:
  - Equity, when the original transaction that resulted in the issuance or assumption of the financial liability was not in the normal course of operations; or
  - Net income when:
    - The original transaction that resulted in the issuance or assumption of the financial liability was in the normal course of operations; or
    - It is impracticable to determine whether the amount extinguished was issued or assumed in the normal or not in the normal course of operations.

*Not for profit organizations must account for the extinguishment of financial liabilities exchanged in a related party non-reciprocal transaction in accordance with Section 4410, *Contributions - Revenue Recognition*.

INTEREST, DIVIDENDS, LOSSES AND GAINS

The classification of an instrument in the Balance Sheet determines whether interest, dividends, losses and gains relating to that instrument are classified as expenses or income and reported in the Income Statement or as a charge to equity*.

- Dividend payments on shares classified as liabilities are classified as expenses and reported in net income.
- Interest on a bond is classified as an expense and reported in net income.
- Gains and losses on redemptions or refinancing of instruments classified as liabilities or equity are reported in net income or as a charge to equity respectively.

*Note that forgiveness of related party assets and derecognition of related party financial liabilities are treated as outlined earlier in the respective forgiveness and derecognition sections of this publication.

[12] Refer to IBOR reform below, which is effective February 1, 2022. For the purpose of this Section, IBOR reform refers to the market-wide reform to replace interbank offered rates (IBORs), including but not limited to the Canadian dollar offered rate (CDOR) and the London interbank offered rate (LIBOR), with alternative benchmark rates.

HEDGE ACCOUNTING

The purpose of hedge accounting is to recognize offsetting gains, losses, revenues and expenses of the hedged item and the hedging instrument in net income in the same period or periods.

Hedge accounting is **optional.**

ELIGIBILITY

A hedging relationship qualifies for hedge accounting only when all of the following conditions are satisfied:

- At the inception of the hedging relationship, the entity designates that hedge accounting will be applied to the hedging relationship and formally documents the hedging relationship;
- Both at the inception of the hedging relationship and throughout its term, the entity has reasonable assurance that the critical terms of the hedging item and the hedged item are the same, as described in paragraphs 3856.A62-.A65 or paragraphs 1651.38-.41; and
- When the hedged item is an anticipated transaction, it is probable the anticipated transaction will occur at the time and in the amount designated.

An entity may designate only the following hedging relationships:

- An anticipated transaction denominated in a foreign currency hedged with a forward contract (see paragraph 3856.A62);
- An anticipated purchase or sale of a commodity hedged with a forward contract (see paragraph 3856.A63-.A63C);
- An interest-bearing asset or liability hedged with an interest rate swap (see paragraph 3856.A64);
- A foreign currency denominated interest-bearing asset or liability hedged with a cross-currency interest rate (see paragraph 3856.A65); and
- The net investment in a self-sustaining foreign operation hedged with a derivative or non-derivative financial instrument (see Section 1651, *Foreign Currency Translation*, paragraphs .38-.41).

RECOGNITION

A hedge of an **anticipated transaction** is accounted for as follows:

- When the anticipated transaction occurs, the hedged item is recognized initially at the amount of consideration received or paid; and
- The forward contract is not recognized until its maturity.
- When the forward contract matures, the gain or loss on the contract is recorded as an adjustment of the carrying amount of the hedged item. When the hedged item is recognized directly in net income, the gain or loss on the forward contract is included in the same category of revenue or expense in the income statement.
- When the forward contract matures <u>before</u> the hedged item is recognized, the gain or loss on the forward contract is recognized as a separate component of equity until the hedged item is recognized. Then when the hedged item is recognized, the gain or loss on the forward contract is transferred from the separate component of equity to the carrying amount of the hedged item or into net income and is included in the same category of revenue or expense in the income statement (see paragraph 3856.A62A).
- When the forward contract matures <u>after</u> the hedged item is recognized, the forward contract is recognized on the same date as the hedged item using the spot price / rate in effect on that date. The resulting gain or loss is included in the carrying amount of the hedged item or in net income, in the same category of revenue or expenses in the income statement, and the offsetting amount is recognized as a derivative-related asset or liability, as appropriate. If a reporting period ends before the forward contract matures, the forward contract is remeasured using the spot price or rate in effect at the reporting period balance sheet date with any gain or loss included in net income. When the forward contract matures, the asset or liability is derecognized and any additional gain or loss on the forward contract is recognized in net income.

A hedge of an **interest bearing asset or liability** is accounted for as follows:

- Interest on the hedged item is recognized using the instrument's stated interest rate plus or minus amortization of any initial premium or discount and any financing fees and transaction costs;
- Net amounts receivable or payable on the interest rate swap are recognized as an adjustment to interest on the hedged item in the period in which they accrue; and
- When applicable, recognized foreign currency receivables and payables on a hedging cross-currency interest rate swap are translated using current exchange rates with gains and losses included in net income in the period in which they arise.

The approach for both types of hedges results in the derivative being accounted for off-balance sheet. This approach is offset by the requirement for disclosures which describe the nature and terms of the hedged item, the nature and terms of the hedging instrument, the fact that hedge accounting applies and the net effect of the relationship.

DISCONTINUANCE

Once a hedging relationship is accounted for using hedge accounting, an entity cannot choose to discontinue hedge accounting. Except as specified in paragraph 3856.36A[13], once hedge accounting is being used for a specific relationship, any entity can only discontinue hedge accounting when:

- The hedge item or the hedging item ceases to exist;
- The critical terms of the hedging item set out in paragraphs 3856.A62-A65 cease to match those of the hedged item, including but not limited to, when:
  - It becomes probable an interest bearing asset or liability hedged with an interest rate or cross currency interest rate swap will be prepaid; and
  - It is no longer probable that an anticipated transaction will occur in the amount designated or within 30 days of the maturity date of the hedging item.

When a hedging item ceases to exist, any gains or losses incurred on its termination are recognized in net income at the same time the hedged item affects net income.

If the hedged item is an anticipated transaction, any gain or loss incurred on the termination of the hedging item is recognized in a separate component of shareholders' equity. When the anticipated transaction occurs, the gain or loss is removed from shareholders' equity and is recognized as an adjustment of the carrying amount of the hedged item.

If the hedged item is a recognized asset or liability, any gain or loss incurred on the termination of the hedging item is recognized as an adjustment of the carrying amount of the hedged item.

When hedge accounting is discontinued, the hedging item is measured as otherwise required by Section 3856 and any gain or loss is recognized in net income.

[13] Refer to IBOR reform below, which is effective February 1, 2022. For the purpose of this Section, IBOR reform refers to the market-wide reform to replace interbank offered rates (IBORs), including but not limited to the Canadian dollar offered rate (CDOR) and the London interbank offered rate (LIBOR), with alternative benchmark rates.

INTEREST RATE BENCHMARK (IBOR) REFORM

DEBT MODIFICATIONS

As a practical expedient, an enterprise that modified one or more contractual terms in a debt instrument because of IBOR reform may choose to account for the modifications as if they are not substantial.

When a modification is not substantial, fees and transaction costs accounted for as adjustments to the original debt instrument continue to be recognized as a component of the carrying amount of the debt instrument, and together, with fees and transaction costs related to the modification, are amortized over the remaining term of the modified debt.

The optional expedient applies to debt modifications if the terms that are modified directly replace, or have the potential to replace IBORs with an alternative benchmark rate.

If other terms are modified at the same time as the replacement of IBOR in a way that changes, or has the potential to change the amount or timing of contractual cash flows, the enterprise must apply the optional expedient to those modifications which are related to the replacement of IBOR with an alternative benchmark rate first. The enterprise will then apply the remaining guidance in the section related to debt modifications.*

* See above related to the derecognition of financial liabilities.

HEDGE ACCOUNTING

The amendments only apply to the following hedging relationships where critical terms are expected to be modified due to IBOR reform:

- An interest-bearing asset or liability hedged with an interest rate swap to mitigate the effect of changes in interest rates; and
- A foreign currency denominated interest-bearing asset or liability hedged with a cross-currency interest rate swap to mitigate the effect of changes in interest rates and foreign currency exchange rates.

An enterprise will continue applying hedge accounting to existing hedging relationships only if all changes made to the contractual terms of a hedging item or a hedged item are directly related to the replacement of IBORs:

- To qualify for this exception, the critical terms of the hedging item and the hedged item shall continue to match after the enterprise makes such changes.
- The contractual items in the hedged item and the reference rate in the hedging item may be replaced at different times. In that case, there will be a temporary period during which the critical terms of the hedged item and the hedging item do not match. During this period, the above exception is applied and hedge accounting continues, provided that the enterprise is actively in the process of replacing the reference rate in the remaining instrument.

Some interest rate swaps and cross-currency interest rate swaps designated as hedging items may be modified through direct contract amendments to effect a change because of IBOR reform. Alternatively, they may be modified to effect the change because of IBOR reform by both:

- Entering into a fully offsetting derivative contract to effectively cancel the original derivative contract; and
- At the same time, entering into a new derivative contract with revised contractual terms.

Both methods of effective changes to contractual changes to contractual terms as a result of IBOR reform qualify for the exception described above.

An enterprise must update its hedge documentation to reflect the changes required by IBOR reform to the hedging item, the hedged item and the description of the specific risk exposure being hedged. For the avoidance of doubt, the amendment to the formal designation of a hedging relationship is not the discontinuation of the hedging relationship nor the designation of a new hedging relationship.

20 Wellington Street East
Suite 500
Toronto ON M5E 1C5
416-865-0111

www.bdo.ca