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ASSURANCE AND ACCOUNTING

A GUIDE TO HEDGE ACCOUNTING FOR PRIVATE ENTERPRISES AND NOT-FOR-PROFIT ORGANIZATIONS

In today's economic environment it is becoming increasingly common for entities to enter into hedging relationships. The most common types of hedging relationship situations include the hedging of:

- Cash disbursements and receipts to and from foreign suppliers and customers with forward foreign currency contracts;
- Commodity prices, which impact the cost of supplies or sales prices, with forward commodity contracts or exchange traded futures; and
- Variable interest rate loans by entering into pay fixed – receive variable interest rate loans.

Although these transactions are very common, many entities choose not to apply hedge accounting due to its complexity and the related costs. Hedge accounting remains optional under Accounting Standards for Private Enterprises (ASPE)[1]. The requirements in ASPE will simplify hedge accounting and thus, entities that were previously not using hedge accounting may now choose to use hedge accounting.

The requirements related to hedge accounting are contained in Section 3856, Financial Instruments. This publication will cover the hedge accounting aspects of Section 3856. All other aspects of Section 3856 are covered in our publication A Guide to Financial Instruments for Private Enterprises and Not-for-Profit Organizations (NPOs).

Qualifying Hedging Relationships[2]

As a compromise to simplifying hedge accounting under ASPE, the relationships to which hedge accounting may be applied has been limited. Therefore, before hedge accounting is even considered, you must determine if the relationship is eligible for hedge accounting.

The qualifying relationships and the related criteria are outlined below. In addition to what is outlined below hedge accounting may also be applied to the net investment in a self-sustaining foreign operation hedged with a derivative or non-derivative financial instrument[3].

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[1] Not-for-Profit entities are required to follow Part III of the CICA Handbook – Accounting. Part III requires them to follow the applicable standards ASPE (including Section 3856 – Financial Instruments) along with additional standards under Part III.
[2] The Accounting Standards Board issued an Exposure Draft in April 2011 expanding the relationships to which hedge accounting may be applied. If approved, these amendments would be effective for fiscal years beginning on or after January 1, 2011. The significant proposed amendments will be footnoted.
[3] The guidance for net investment hedges is described in Section 1651, Foreign Currency Translation.

Anticipated Purchase or Sale of a Commodity Hedged with a Forward Contract

An entity may designate a forward contract as a hedge of an anticipated purchase or sale of a commodity when and only when:

- The forward contract is for the purchase or sale of the same quantity of the same commodity and at the same location[4] as the hedged anticipated purchase or sale;
- The forward contract matures within two weeks[5] of the date of the hedged anticipated purchase or sale;
- It is probable the anticipated purchase or sale will occur at the time and in the amount expected; and
- The fair value of the forward contract at the inception of the hedging relationship is zero.

Anticipated Transaction Denominated in a Foreign Currency Hedged with a Forward Contract

An entity may designate a foreign exchange forward contract as a hedge of an anticipated foreign currency cash flow when and only when:

- The forward contract is for the purchase or sale of the same amount of the same currency designated as the hedged anticipated cash flow;
- The forward contract matures within two weeks[6] of the date of the hedged anticipated cash flow;
- It is probable the anticipated foreign currency cash flow will occur at the time and in the amount expected; and
- The fair value of the forward contract at the inception of the hedging relationship is zero.

An Interest Bearing Asset or Liability Hedged with an Interest Rate Swap

An entity may designate an interest rate swap as a hedge of interest rate risk exposure in a recognized interest bearing asset or liability when and only when all of the applicable criteria in the following list are satisfied:

- The notional amount of the swap matches the principal amount of the interest bearing asset or liability that is designated as the hedged item;
- The fair value of the swap at the inception of the hedging relationship is zero;
- The formula for computing net settlements under the interest rate swap is the same for each net settlement. Accordingly, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment;
- The interest bearing asset or liability is not prepayable (i.e. able to be settled by either party prior to its scheduled maturity), unless the instrument is repayable due to an embedded put or call and the swap has a mirror image of the embedded put or call;[7]
- The index on which the variable leg of the swap is based matches the interest rate designated as the interest rate risk being hedged for that hedging relationship;
- The swap matures within two weeks of the maturity date of the designated financial asset or liability;
- There is no floor or ceiling on the variable interest rate of the swap;
- In the case of a hedge of a fixed rate asset or liability, the interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less); and
- In the case of a hedge of a variable rate asset or liability, the repricing dates are within two weeks of those of the variable rate asset or liability.

A Foreign Currency-denominated Interest Bearing Asset or Liability Hedged with a Cross-currency Interest Rate Swap

An entity may designate a cross-currency interest rate swap as a hedge of a recognized foreign currency interest bearing asset or liability when and only when all of the applicable criteria in the above for an interest rate swap apply, except as follows:

- When settlements of a cross-currency interest rate swap are not on a net basis, the formula for computing the gross settlement amounts are the same for each settlement. Accordingly, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment;
- The currency of one leg of the swap is the same as the currency in which the underlying hedged asset or liability is denominated and the currency of the other leg of the swap is the same as the currency in which the reporting entity measures the underlying hedged asset or liability in its financial statements; and
- When multiple swaps are used, the combined effect of all of the swaps is that the currency of one leg of the swaps is the same as the currency in which the underlying hedged asset or liability is denominated and the currency of the other leg of the swaps is the same as the currency in which the reporting entity measures the underlying hedged asset or liability in its financial statements.

[4] The Exposure Draft proposes to eliminate the requirement for the location to be the same, but it will require the grade or purity to be the same as the hedged transaction.
[5] The Exposure Draft proposes to increase the timing to 30 days.
[6] The Exposure Draft proposes to increase the timing to 30 days.
[7] The Exposure Draft proposes to allow hedge accounting if it is probable that the amount will not be prepaid.

Conditions to Use Hedge Accounting

In addition to the hedging relationship needing to qualify for hedge accounting, certain conditions must also be met to apply hedge accounting. At inception of the hedging relationship, the entity must designate that hedge accounting will be applied and formally document the hedging relationship by identifying the hedged item, the related hedging item, the nature of the specific risk exposure or exposures being hedged and the intended term of the relationship. The documentation requirements in pre-changeover GAAP were significant and costly to complete and resulted in many entities not using hedge accounting. Although documentation requirements still exist, the requirements are significantly less than what was required under pre-changeover GAAP. The following is an example of what hedge documentation would look like for variable rate loan hedged with an interest rate swap.

> The Company has designated that hedge accounting will be applied to the following hedge relationship:
>
> - Hedged item – 5 year $500,000 loan with interest at prime+3% with ABC Bank; and
> - Hedging item – 5 year pay floating (prime) – received fixed (5%) swap with a notional value of $500,000.
>
> The critical terms and conditions of the loan and swap match.
>
> The relationship was entered into by the Company to hedge the interest rate risk associated with the floating rate loan over its 5 year term.

In addition to the documentation, there must be reasonable assurance that the critical terms will match at inception and throughout the term of the hedging relationship. If the criteria discussed above related to qualifying hedging relationships are met, the entity can conclude that the critical terms will match. Lastly, if the transaction being hedged is an anticipated transaction, it must be probable that the transaction will occur at the time and amount designated.

Hedge Accounting

The purpose of hedge accounting is to recognize offsetting gains, losses, revenues and expenses of the hedged items and the hedging instrument in net income in the same period or periods. The actual accounting will depend on whether it is a hedge of an anticipated transaction or a hedge of interest rate risk.

A hedge of an anticipated transaction is accounted for as follows[8] :

- When the anticipated transaction occurs, it 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.

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 items, the nature of terms of the hedging instrument, the fact that hedge accounting applies and the net effect of the relationship.

It should also be noted that once a hedging relationship is accounted for using hedge accounting, an entity cannot choose to discontinue hedge accounting. Once hedge accounting is being used for a specific relationship, it can discontinue hedge accounting only when[9]:

- The hedge item or the hedging item ceases to exist;
- The critical terms of the hedging item cease to match those of the hedged item; or
- It is no longer probable that an anticipated transaction will occur in the amount designated or within two weeks 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.

[8] The Exposure Draft proposes amendments to clarify how to account situations when the forward contract matures before or after the anticipated transaction.
[9] The Exposure Draft proposes to require discontinuance of hedge accounting if it becomes probable that the liability which is hedged will be prepaid.

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 a hedged item ceases to exist, the critical terms of the hedging item cease to match those of the hedged item, or it is no longer probable that an anticipated transaction will occur in the amount designated or within two weeks of the maturity date of the hedging item, the hedging item is measured as otherwise required by Section 3856 and any gain or loss is recognized in net income.

First-Time Adoption

Section 1500, First-Time Adoption, requires hedge accounting to be applied prospectively. As a result, an entity measures in its opening balance sheet, derivatives for which hedge accounting is not being applied at fair value and eliminates all deferred losses and gains arising on derivatives that were reported previously as if they were assets or liabilities.

In addition, an entity does not reflect in its opening balance sheet a hedging relationship of a type that does not qualify for hedge accounting under Section 3856. If, before the date of transition to ASPE, an entity had designated a hedging relationship using criteria that are the same as that in Section 3856, the entity adjusts the carrying amounts of the hedged and hedging items to the amount that would have been recognized had Section 3856 always applied. Transactions entered into before the date of transition to ASPE cannot be retrospectively designated as hedges.

Conclusion

On the adoption of ASPE the adoption of Section 3856, Financial Instruments, will be a significant change for most entities. In the case of hedge accounting, it will actually be a simplification and will potentially make hedge accounting more accessible to you and your organization. Talk to your BDO advisor to understand the impact it will have on you.

[10] For NPOs, the Section is 1501, First-Time Adoption under Part III of the CICA Handbook – Accounting.