

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 perceived complexity and the related costs. However, hedge accounting under Accounting Standards for Private Enterprises (ASPE) is a simplified model. Applying hedge accounting remains optional for private sector entities under ASPE and private sector not-for-profit organizations (NPOs) under Accounting Standards for Not-for-Profit Organizations (ASNPO)¹.

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* available on bdo.ca.

Qualifying Hedging Relationships

To simplify 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 instrument².

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, or a group of anticipated purchases or sales of a commodity, when and only when:

- The commodity forward contract is for the purchase or sale of the same quantity and similar grade of purity of the same commodity as the designated hedged anticipated purchases or sales;
- It is probable that each hedged anticipated purchase or sale will occur within 30 days of the maturity of the commodity forward contract;
- It is probable that each anticipated commodity purchase or sale will occur at the time and in the amount expected; and

¹Private sector not-for-profit entities are required to follow Part III of the CPA Canada Handbook – Accounting. Part III requires them to follow the applicable standards in ASPE (including Section 3856 – *Financial Instruments*) along with additional standards under Part III.

²The guidance for net investment hedges is described in Section 1651, *Foreign Currency Translation*.

- The fair value of the forward contract at the inception of the hedging relationship is zero.

Refer to paragraphs 3856.A63A-.A63C for additional guidance on such hedging transactions.

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 transaction, or a group of foreign currency transactions, when and only when:

- The forward contract is for the purchase or sale of the same amount of the same currency as the designated hedged anticipated transaction or group of transactions;
- The forward contract matures within 30 days of the settlement of each designated anticipated transaction;
- It is probable the settlement of each anticipated foreign currency transaction 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.

Refer to paragraph 3856.A62A for additional guidance on such hedging transactions.

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;
- It is probable that the instrument will not be prepaid
- 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 listed 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.

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. First, 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 hedging relationship. 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 above documentation, there must be reasonable assurance that the critical terms of the hedging item and the hedged item 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 qualifying 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 payable or receivable. The recognition of the hedging item (forward contract) will depend on when it matures:

- When the hedging item (forward contract) matures at the same time as the hedged item.

- The forward contract is not recognized until it matures. When it does mature, the gain or loss on the forward contract is recorded as an adjustment of the carrying amount of the hedged item when the anticipated transaction results in the recognition of an asset or liability. 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 hedging item (forward contract) matures before 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 value of the hedged item or to net income and is included in the same category of revenue or expense in the income statement.
- When the hedging item (forward contract) matures after the hedged item is recognized:
 - The forward contract is recognized on the same date as the hedged item using the spot price or rate in effect on that. 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 expense in the income statement, and the offsetting amount is recognized as a derivative-related asset or liability, as appropriate. If the 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 derivative-related asset or liability is derecognized, the hedging item is recognized at the settlement amount, and any additional gain or loss on the forward contract is recognized in net income.

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

- Interest on the hedged item is recognized using the hedged items 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 hedging item (i.e. 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 cross-currency interest rate swap hedging item 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 and 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:

- The hedged item or the hedging item ceases to exist other than as designated or documented;
- The critical terms of the hedging item cease to match those of the hedged item including but not limited to, when;
 - It becomes probable that an interest bearing asset or liability hedged with an interest rate or cross currency interest rate swap will be prepaid; and
 - The hedged item is an anticipated transaction and it is no longer probable that the anticipated commodity purchase or sale transaction or the settlement of the anticipated foreign currency transaction will occur in the amount designated or within 30 days of the maturity date of the hedging forward contract.
- 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 a hedged item ceases to exist, the critical terms of the hedging item cease to match those of the hedged item, it becomes probable that the interest-bearing hedged item will be prepaid, or 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, then the hedging item is measured as otherwise required by Section 3856 and any gain or loss is recognized in net income.

First-Time Adoption of ASPE

When adopting ASPE for the first time, Section 1500, *First-Time Adoption*, requires hedge accounting to be applied prospectively.³ As a result, an entity measures in its opening balance sheet, derivatives for which hedge accounting is not being applied at fair value.

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

If your organization is entering into hedging transactions, talk to your BDO advisor to determine whether applying hedge accounting is right for you.

³ For NPOs, the Section is 1501, *First-Time Adoption*, under Part III of the CPA Canada Handbook – Accounting.

The information in this publication is current as of January 31, 2021.

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