

**ACCOUNTING STANDARDS BOARD
PROPOSED ACCOUNTING RECOMMENDATIONS**

Hedges

March 2003

**COMMENTS MUST BE RECEIVED BY
JULY 31, 2003**

This Exposure Draft of proposed accounting standards is issued by the Accounting Standards Board. The Board is composed of persons knowledgeable in the preparation and use of financial statements who are drawn from public practice, business and academe. All members serve as individuals and not as representatives of their employers or organizations.

Individuals and organizations are invited to send written comments on the Exposure Draft proposal. Comments are requested from those who agree with the Exposure Draft as well as from those who do not.

Comments are most helpful if they are related to a specific paragraph or group of paragraphs, clearly explain the problem, and include a suggested alternative supported by specific reasoning. All comments received will be available on a public file one month after the Accounting Standards Board has discussed the comment letters, unless confidentiality is requested.

To be considered, comments must be received by July 31, 2003, addressed to:

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**The Exposure Draft is available on the Internet:
www.cica.ca/ed**

"Recommendations need not be applied to immaterial items. While materiality is a matter of professional judgment in the particular circumstances, the Board believes that, as a general rule, materiality should be judged in relation to the significance of financial statement information to decision makers. An item of information, or an aggregate of items, should be deemed to be material if it is probable that its omission or misstatement would influence or change a decision."

(Introduction to Accounting Recommendations – CICA Handbook – Accounting)

Highlights

The Accounting Standards Board (AcSB) proposes, subject to comments received following exposure, to issue new Handbook Section 3865, HEDGES. This Exposure Draft proposes that:

- The existing requirements of ACCOUNTING GUIDELINE AcG-13, Hedging Relationships (AcG-13), be combined with new requirements for hedge accounting in a new Handbook Section, HEDGES.
- Hedges be designated as either fair value hedges, cash flow hedges or hedges of a net investment in a self-sustaining foreign operation.
- For a fair value hedge, the gain or loss on a derivative hedging item, or the gain or loss on a non-derivative hedging item attributable to the hedged risk, is recognized in net income in the period of change together with the offsetting loss or gain on the hedged item attributable to the hedged risk. The carrying amount of the hedged item is adjusted for the hedged risk.
- For a cash flow hedge, the effective portion of the hedging item's gain or loss is initially reported in other comprehensive income and subsequently reclassified to net income when the hedged item affects net income.
- For a hedge of a net investment in a self-sustaining foreign operation the same accounting is followed as for a cash flow hedge.
- New disclosures are provided about an entity's accounting for designated hedging relationships.

Background

These proposals are part of the AcSB's project on financial instruments, which include accompanying Exposure Drafts on proposed Handbook Section 3855, FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, and Section 1530, COMPREHENSIVE INCOME. Those Exposure Drafts propose to introduce standards on recognition and measurement of financial instruments and comprehensive income that will be harmonized with standards issued by the US Financial Accounting Standards Board (FASB).

An integral part of FASB standards on recognition and measurement of financial instruments is the ability to elect to apply hedge accounting in certain circumstances. Existing Canadian guidance on accounting for hedges is limited to FOREIGN CURRENCY TRANSLATION, Section 1650, which addresses accounting for foreign currency hedges; and AcG-13, which addresses when hedge accounting may be used, as well as when and how it should be discontinued. Existing Canadian guidance does not comprehensively address how to account for hedges. Accordingly, the AcSB proposes to introduce hedge accounting requirements that are harmonized with those in the US.

The AcSB proposes to incorporate the existing requirements in AcG-13 (as proposed to be clarified in the draft issued for comment by February 28, 2003) for when hedge accounting may be used and when and how it may be discontinued unchanged, except for the consequential effects of its other proposals in its financial instruments project. This Exposure Draft includes only the February 2003 proposed amendments to AcG-13. It does not include any further changes to AcG-13 that the AcSB may make as a result of its redeliberation of these February 2003 proposed amendments. Any further changes to AcG-13 will be taken into account in finalizing Handbook Section 3865, HEDGES.

Proposals

These proposals should be read in conjunction with the accompanying Background Information and Basis for Conclusions document.

The main features of the Exposure Draft are as follows.

Hedging relationships

- A hedging relationship qualifies for hedge accounting under the same circumstances as in existing AcG-13, except as follows:
 - The hedged item cannot be an unrecognized asset or liability, such as an unrecognized intangible.
 - The hedged item cannot be an embedded derivative, except in limited circumstances.
 - The hedging item is restricted to all or a specified percentage of an entire derivative, an entire non-derivative financial asset or an entire non-derivative financial liability, or all or a specified percentage of an entire group of derivatives, non-derivative financial assets or non-derivative financial liabilities. Thus, the hedging item cannot be, for example, an anticipated transaction.
 - Internal hedging arrangements qualify for hedge accounting only when the hedge is a cash flow hedge of foreign currency risk in an anticipated transaction.
 - Restrictions are placed on the use of financial instruments designated as held to maturity in hedging relationships.

Hedge accounting

- For a hedging item designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a previously unrecognized firm commitment or an identified portion of such an asset, liability or firm commitment (a fair value hedge), the gain or loss on a derivative hedging item, or the gain or loss on a non-derivative hedging item attributable to the hedged risk, is recognized in net income in the period of change together with the offsetting loss or gain on the hedged item attributable to the hedged risk. The carrying amount of the hedged item is adjusted for the hedged risk.
- For a hedging item designated as hedging the exposure to variability in cash flows that is attributable to a particular risk associated with a recognized asset or liability or a forecasted transaction or, in the case of a hedge of foreign currency risk only, a firm commitment (a cash flow hedge), the effective portion of the hedging item's gain or loss is initially reported in other comprehensive income (see accompanying Exposure Draft, "Comprehensive Income") and subsequently reclassified to net income when the hedged item affects net income.
- For a hedge of a net investment in a self-sustaining foreign operation the same accounting is followed as for a cash flow hedge.

Discontinuing hedge accounting

- Hedge accounting is discontinued under the same circumstances as in existing AcG-13.

Disclosures

- An entity that designates hedging relationships discloses information that enables users of the financial statements to understand the entity's objectives for holding or issuing the hedging items, the context needed to understand those

objectives, its strategies for achieving those objectives, and the effect of hedge accounting on the financial statements.

Consistency with US and international requirements

The AcSB believes that the proposals in this Exposure Draft are not in conflict with the requirements of US generally accepted accounting principles. However, in some circumstances the proposals permit additional alternatives that are not available in accordance with US GAAP. The proposals are also generally consistent with the requirements of International Financial Reporting Standards.

Plans for finalizing the proposals

The AcSB expects to issue its proposals by the second quarter of 2004 with an effective date for fiscal years beginning on or after October 1, 2004.

The AcSB will redeliberate these proposals to take into account comments received on this Exposure Draft. As part of its redeliberations, the AcSB expects to hold one or more roundtable discussions of significant matters arising from the proposals. The AcSB expects to invite all individuals and organizations that submit comment letters on the proposals to participate. The AcSB will provide updates about its redeliberations on its web page at www.acsbcanda.org.

Comments requested

The AcSB welcomes comments on all aspects of the proposed new Handbook Section 3865, HEDGES. However, commentators should note that the AcSB plans to amend material incorporated from AcG-13 only in accordance with its overall approach to introducing its other requirements on recognition, measurement and hedge accounting. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, clearly explain the problem and provide a suggestion for alternative wording with supporting reasoning.

The AcSB particularly welcomes comments on the following questions concerning the proposals:

1. Do you agree with the manner in which the existing requirements of AcG-13 have been incorporated into the proposed new Section? If not, why not? What additional changes should be made to that material, and why?
2. Do you agree with the proposed modifications to AcG-13 as it has been incorporated into the proposed new Section? If not, what changes would you suggest, and why?
3. Do you agree with the proposals for accounting for fair value hedges, cash flow hedges and hedges of a net investment in a self-sustaining operation, in paragraphs 3865.38-.47? If not, what changes would you suggest, and why?
4. Do you agree with the proposed disclosures in paragraphs 3865.50-.56? If not, what changes would you make, and why?
5. Do you agree that the proposals are not in conflict with the requirements of US generally accepted accounting principles? If you believe that they are in conflict, please explain the conflict and suggest how it might be resolved.
6. Do you have any other comments on the proposals? If so, please specify.

Hedges, Section 3865

PROPOSAL

This proposed Handbook Section would replace ACCOUNTING GUIDELINE AcG-13, Hedging Relationships (AcG-13). Text that is based on the proposed amendments to AcG-13, issued for comment in February 2003, is grey-shaded with additional text denoted by underlining and deleted text denoted by strikethrough. Significant new text is not shaded.

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PURPOSE AND SCOPE

.01 This Section establishes standards for when and how hedge accounting may be applied. Hedge accounting is optional. The Section is applied by all entities that choose to apply hedge accounting.

OBJECTIVE AND BASIC PRINCIPLES

.032 Hedging is an activity designed to modify an entity's exposure to one or more risks, by creating an offset between changes in the fair value of, or the cash flows attributable to, the hedged item and the hedging item (or changes resulting from a particular risk exposure relating to those items).

- .03** The purpose of hedge accounting is to ensure that counterbalancing gains, losses, revenues and expenses (including the effects of counterbalancing changes in cash flows) are recognized in net income in the same period or periods. Hedge accounting is applied only when gains, losses, revenues and expenses on a hedging item would otherwise be recognized in net income in a different period than gains, losses, revenues and expenses on the hedged item. There are many hedging relationships for which hedge accounting is unnecessary because gains, losses, revenues and expenses on the hedging item and counterbalancing gains, losses, revenues and expenses on the hedged item are recognized in net income in the same period.
- .04** Hedge accounting modifies the normal basis for recognizing the gains, losses, revenues and expenses associated with a hedged item or a hedging item in an entity's income statement. ~~Accordingly, an entity should apply hedge accounting only under conditions that justify its use.~~
- .05** This Section is based on the same four fundamental decisions serving as cornerstones to FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, Section 3855:
- (a) Financial instruments and non-financial derivatives represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements. Accordingly, this Section does not affect whether a financial instrument or other derivative is reported in the financial statements.
 - (b) Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative financial instruments. Accordingly, the special accounting permitted by this Section does not affect the basic requirement that all derivative financial instruments should be measured at fair value.
 - (c) Only items that are assets or liabilities should be reported as such in financial statements. Accordingly, this Section does not permit gains or losses on hedging items to be deferred on the balance sheet as if they were assets or liabilities.
 - (d) Special accounting for items designated as being part of a hedging relationship should be provided only for qualifying items. Accordingly, this Section contains requirements that specify when a hedge may qualify for special accounting.

DEFINITIONS

- .056** The following terms are used in this Section with the meanings specified:
- (a) **Hedge accounting** is a method for recognizing the gains, losses, revenues and expenses associated with the items in a hedging relationship, such that those gains, losses, revenues and expenses are recognized in net income in the same period when they would otherwise be recognized in different periods.
 - (b) A **hedging relationship** is a relationship established by an entity's management between a hedged item and a hedging item, ~~including a synthetic instrument relationship~~ that satisfies all of the conditions in this Guideline Section.
 - (c) A **hedged item** is all or a specified portion of an recognized asset, a recognized liability, ~~or~~ an anticipated transaction, or a net investment in a self-sustaining foreign operation, or a group of similar recognized assets, recognized liabilities or anticipated transactions, having an identified risk exposure that an entity has taken steps to modify.

- (d) A **hedging item** is all or a specified percentage of an entire derivative, an entire non-derivative financial asset, or an entire non-derivative financial liability, or an entire anticipated transaction, or all or a specified percentage of an entire group of derivatives, non-derivative financial assets or non-derivative financial liabilities or anticipated transactions, offsetting a risk exposure identified in the hedged item, provided that non-derivative items in a group are all similar.
- (e) A **fair value hedge** is a hedge of the exposure to changes in fair value of a recognized asset or liability or a previously unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect reported net income.
- (f) A **cash flow hedge** is a hedge of the exposure to variability in cash flows that:
 - (i) is attributable to a particular risk associated with a recognized asset or liability (such as all or a specified portion of future interest payments on variable rate debt), or a forecasted transaction (such as a forecasted purchase or sale), or, in the case of a hedge of foreign currency risk only, a firm commitment; and
 - (ii) could affect reported net income.
- (g) A **hedge of a net investment in a self-sustaining foreign operation** is a hedge of the foreign currency exposure of a net investment in a self-sustaining foreign operation (see FOREIGN CURRENCY TRANSLATION, Section 1650).
- (h) An **anticipated transaction** is any transaction expected to occur in the future that has not yet given rise to a recognized asset or liability.
- (i) A **firm commitment** is an agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:
 - (i) The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of the currency in which an entity measures the items in its financial statements or of another currency. It may also be expressed as a specified interest rate or specified effective yield.
 - (ii) The agreement includes a disincentive for non-performance that is sufficiently large to make performance probable.
- (j) A **forecasted transaction** is an anticipated transaction for which there is no firm commitment.
- (k) **Hedge effectiveness** is the extent to which changes in the fair value or cash flows of a hedged item relating to a risk being hedged and arising during the term of a hedging relationship are offset by changes in the fair value or cash flows of the corresponding hedging item relating to the same risk and arising during the same period.

CONDITIONS FOR APPLYING HEDGE ACCOUNTING

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

- (a) *At the inception of the hedging relationship, the entity should have:*
 - (i) *identified the nature of the specific risk exposure or exposures being hedged in accordance with its risk management objective and strategy (see paragraphs 3865.089-.1820); and*

- (ii) *designated that hedge accounting will be applied to the hedging relationship (see paragraphs 3865.1921-2123).*
- (b) *At the inception of the hedging relationship, the entity should have formal documentation of:*
 - (i) *its risk management objective and strategy for establishing the relationship;*
 - (ii) *the hedging relationship, 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;*
 - (iii) *the method for assessing the effectiveness of the hedging relationship; and*
 - (iv) *the method of accounting for the hedging relationship, including the income recognition of the gains, losses, revenues and expenses associated with the items in the relationship.*
- (c) *Both at the inception of the hedging relationship and throughout its term, the entity should have reasonable assurance that the relationship will be effective, consistent with the entity's originally documented risk management objective and strategy. Accordingly:*
 - (i) *the effectiveness of the hedging relationship should be reliably measurable, which requires that the effects of the risk exposure being modified be reliably measurable for the hedged item and the hedging item;*
 - (ii) *the hedging relationship should be assessed on a regular periodic basis over its term to determine that it has remained, and is expected to continue to be, effective (see paragraphs 3865.2224-3536); and*
 - (iii) *in the case of a hedging relationship involving an ~~anticipated~~ forecasted transaction, it should be probable that the transaction will occur and present an exposure to variations in cash flows ultimately affecting net income.*

.08 A hedged anticipated transaction would be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. Therefore, an anticipated transaction may be identified as the sale of the first 10,000 units of a specific product during a specified three-month period, but it could not be identified as the last 10,000 units of that product sold during a three-month period because the last 10,000 units cannot be identified when they occur. For the same reason, an anticipated transaction cannot be specified solely as a percentage of sales or purchases during a period.

~~**.07** Hedge accounting is optional because an entity has the choice of designating that it will be applied to a particular hedging relationship. Accordingly, an entity discloses its accounting policy for hedging relationships in accordance with DISCLOSURE OF ACCOUNTING POLICIES, Section 1505.~~

HEDGING RELATIONSHIPS

.089 A hedging relationship may be formed by a combination of items, such as:

- (a) a monetary item or items with a derivative financial instrument or instruments;
- (b) an anticipated transaction or transactions with a monetary item or items;

or

- (c) an anticipated transaction or transactions with a derivative instrument or instruments.

~~An anticipated transaction cannot be the hedged item when the hedging item is itself an anticipated transaction, and a derivative instrument, whether freestanding or embedded, cannot be the hedged item unless it is a put option, a call option, an interest rate cap or an interest rate floor embedded in an existing asset or liability that is not an embedded derivative accounted for separately in accordance with FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, Section 3855, embedded in a non-derivative asset, liability or anticipated transaction. If the entire asset or liability comprising the hedged item is an instrument with variable cash flows, the hedged item cannot be deemed an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows. All or a specified percentage of an entire freestanding derivative instrument may be the hedging item.~~

- ~~0910~~ Various separate risk exposures giving rise either to changes in fair values or to changes in cash flows may be identified for a financial instrument or an anticipated transaction involving a financial instrument, such as interest rate risk (including, but not limited to, the risk-free rate), currency (foreign exchange) risk, credit risk and liquidity risk (see FINANCIAL INSTRUMENTS — DISCLOSURE AND PRESENTATION, paragraph 3860.44). Each risk exposure may be hedged separately or, alternatively, more than one exposure may be hedged within a single hedging relationship.
- ~~101~~ In the case of an item that is not a financial instrument (other than a recognized loan servicing right or a non-financial firm commitment with financial components), it is possible to identify, and thus be able to hedge, only an overall exposure to the risk of changes in the fair value of, or cash flows attributable to, the item. Accordingly, such an item may be designated as a hedged item only in its entirety for all risks and all resulting variability in fair value or cash flows. However, the foreign exchange risk related to an anticipated acquisition or sale of a non-financial instrument may be hedged separately (see FOREIGN CURRENCY TRANSLATION, paragraph 1650.51). An entity identifies the specific assets, liabilities and anticipated transactions, or portions thereof, in a hedging relationship, as well as the specific risk exposure or exposures being hedged, and documents them formally at the time the relationship is designated as a hedge for financial reporting purposes.
- ~~112~~ A hedging relationship established for a period less than the term to maturity of either the hedged item or the hedging item (partial-term hedge) qualifies for hedge accounting provided the term of the relationship is designated on inception and all of the other conditions for hedge accounting are satisfied. It is generally difficult to achieve an effective partial-term fair value hedge, particularly when the hedging item has a term to maturity significantly shorter than the term to maturity of the hedged item.

Groupings of assets, liabilities and anticipated transactions

- ~~123~~ Assets may be grouped together as a hedged item or as a hedging item in a fair value hedging relationship only when they are similar and all share a specific, identified risk exposure or exposures. In determining whether all of the financial assets in a group are similar, an entity considers factors such as the following, when they are applicable:

- (a) the type of assets;
- (b) the nature and terms of any collateral;
- (c) the interest rate type (fixed or variable) and, in the case of fixed-rate assets, the coupon rate;
- (d) the currency in which the assets are denominated; and
- (e) the scheduled maturity date and, in the case of prepayable assets, the prepayment terms, past prepayment history and expected future prepayment performance.

In a hedge of an exposure to changes in fair value, changes in fair value attributable to the hedged risk exposure for each individual asset in a hedged group ~~should be~~ expected to correspond in a generally proportionate manner to changes in fair value attributable to the hedged risk exposure for the group as a whole.

- .134** Liabilities may each be grouped together as a hedged item or as a hedging item in a fair value hedging relationship on the same basis as assets. Some of the factors listed in paragraph ~~3865.4213~~ may be applicable in determining whether all of the financial liabilities in a group are similar. Liabilities ~~should be~~ grouped only with other liabilities as a single hedged item or hedging item and, similarly, assets ~~should be~~ grouped only with other assets, and anticipated transactions only with other anticipated transactions.
- .145** A group of anticipated transactions is eligible for designation as the hedged item in a cash flow hedge when the individual transactions in the group share the same risk exposure for which they are designated as being hedged. Thus, an anticipated purchase and an anticipated sale cannot both be included in the same group of transactions that constitute the hedged item.
- .156** Hedge accounting may be applied to some hedging relationships involving groups of assets, groups of liabilities, or groups of anticipated transactions, but not to a net exposure arising from such items. There is no way of determining when a net exposure has been settled and, accordingly, no way of determining when to recognize previously deferred gains, losses, revenues or expenses in the income statement. When an entity with a net exposure arising from a group of assets and a group of liabilities both exposed to the same type of risk chooses to hedge that exposure, for accounting purposes the entity designates specific assets or liabilities that are considered to be exposed to the hedged risk. For example, when an entity has \$1,000,000 of assets and \$900,000 of liabilities with risks and terms of a similar nature and wishes to hedge the net exposure of \$100,000, it may designate a group of specific assets worth \$100,000 as the hedged item. The same approach may be adopted with individual assets, liabilities and anticipated transactions by hedging an exposed portion of such items, as long as it is possible to identify specifically the individual hedged item and the hedging item, and to determine when the hedged exposure has been settled.

Internal hedging arrangements

- .167** An individual entity within a consolidated group may enter into a contract with another entity within the same consolidated group, such as a treasury centre, for hedging purposes. Such an arrangement may also arise between two divisions of a single entity. For financial reporting purposes, internal hedging arrangements of this nature qualify for hedge accounting treatment only ~~under~~ when all of the following conditions are met:

- (a) The hedge is a cash flow hedge of foreign currency risk in an anticipated transaction.
- (ab) From the perspective of the entity or division establishing a hedging relationship, the relationship satisfies all of the conditions for hedge accounting (see paragraph 3865.067).
- (bc) The entity or division not using the asset, liability or firm commitment arising from the internal hedging contract as a hedging item (the “issuing affiliate”) enters into one or more contracts with unrelated parties to offset its risk exposure or exposures that result from the internal hedging contract. An issuing affiliate’s individual risk exposures (for example, individual foreign currency exposures) from multiple internal hedging contracts may be aggregated or netted for this purpose as long as:
 - (i) the term to maturity of the contract with an unrelated party is substantially the same as the term to maturity of each of the internal hedging contracts and offsets the same aggregate or net risk exposure;
 - (ii) the issuing affiliate tracks the risk exposure that it assumes from each hedging affiliate and maintains documentation supporting the linkage between each internal hedging contract and the offsetting aggregate or net hedging contract with an unrelated party; and
 - (iii) the hedging contract with an unrelated party is not altered or terminated unless the hedging affiliate initiates such action.

The application of hedge accounting to internal hedging arrangements, which is an exception to the general guidance in paragraphs 3865.089-.156, is acceptable only in the circumstances described in this paragraph.

Synthetic instruments

~~.17 Hedging relationships include synthetic instruments, which involve relationships between two or more distinct assets or liabilities (commonly a primary financial asset or liability and a derivative financial instrument) for the purpose of emulating the net cash flows or other characteristics of a single asset or liability. The objective of synthetic instrument accounting is to account for the assets and liabilities in a synthetic instrument relationship as though they were the item being emulated. Synthetic instrument accounting may include some modification to the normal basis for recognizing the gains, losses, revenues and expenses associated with the separate assets and liabilities comprising a synthetic instrument. Accordingly, synthetic instrument accounting is subject to the conditions in this Guideline for applying hedge accounting, with the result that only those synthetic instruments satisfying the conditions in paragraph 6 qualify for the application of synthetic instrument accounting.~~

Held-to-maturity investments

- .18 Held-to-maturity investments carried at amortized cost may be effective hedging items with respect to risks from changes in foreign exchange rates.
- .19 A held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can

be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.

Items ineligible for hedge accounting

.1820 Not all items can form part of a hedging relationship to which hedge accounting applies, as indicated by the following examples.

- (a) Hedge accounting does not apply to investments accounted for by the equity method, other than as permitted by ~~FOREIGN CURRENCY TRANSLATION, Section 1650~~, this Section in respect of a net investment in a self-sustaining foreign operation. The equity method is inconsistent with the concepts underlying hedge accounting because it does not involve periodic recognition of changes in the fair value of an investment or changes in the cash flows from it.
- (b) Hedge accounting does not apply to a non-controlling interest in a subsidiary because such interests are not liabilities of the parent entity.
- (c) Hedge accounting does not apply to financial instruments classified by the issuer as equity ~~pursuant to~~ in accordance with FINANCIAL INSTRUMENTS — DISCLOSURE AND PRESENTATION, Section 3860. Hedge accounting also does not apply to capital transactions of the issuer, such as the anticipated sale, purchase or redemption of financial instruments classified as equity or the declaration of dividends.
- (d) Hedge accounting does not apply to an accrued benefit liability or asset for employee future benefits because the balance represents the net amount of several elements with quite different characteristics. The individual elements are exposed to different types of risks and some may not be exposed to any risk. However, a hedging relationship that qualifies for hedge accounting under this Guideline Section may be established within an employee future benefit plan.
- (e) Hedge accounting does not apply to anticipated business combinations, anticipated acquisitions of investments to be accounted for by the equity method or anticipated transactions involving a parent's interest in a subsidiary, except for hedges of foreign exchange risk thereon. However, ~~entities~~ an entity may hedge the anticipated issue of debt used to fund an anticipated business combination or acquisition.
- (f) Hedge accounting does not apply to an investment in an equity instrument that does not have a quoted market price in an active market and that is measured at cost in accordance with FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, paragraph 3855.59(c).

Similarly, the requirements in paragraphs ~~3865.089-.156~~ preclude the application of hedge accounting to “macro hedges” and similar risk management strategies.

DESIGNATION OF A HEDGING RELATIONSHIP

.1921 Hedge accounting is optional, and management of an entity can decide not to designate hedging relationships that otherwise qualify for hedge accounting. Accordingly, one of the hedge accounting conditions is that management designate a hedging relationship as such for purposes of applying hedge accounting, identifying the specific items included in the hedging relationship and the period over which the hedging relationship is intended to be effective. The designation of the hedging relationship is documented formally in the entity's records when designation occurs.

- .202** Designation of a hedging relationship subsequent to the initial recognition of one of the components of the hedging relationship by an entity is possible, but does not result in any recognition of the hedging relationship for hedge accounting purposes prior to the date of designation.
- .213** Management of an entity may decide, at its discretion, to discontinue hedge accounting for a specific hedging relationship by terminating the designation of that relationship. A different qualifying hedging relationship could then be designated, involving one of the original components in the new hedging relationship. In those circumstances, hedge accounting for the new hedging relationship commences prospectively from the date the new hedging relationship is designated.

EFFECTIVENESS OF A HEDGING RELATIONSHIP

- .224** FOREIGN CURRENCY TRANSLATION, paragraph 1650.50, requires that “If a foreign exchange contract, asset, liability or future revenue stream is to be regarded as a hedge of a specific foreign currency exposure ... there should be reasonable assurance that it is and will continue to be effective as a hedge.” For an entity to have reasonable assurance of the effectiveness of a hedging relationship, both at its inception and ~~on an ongoing basis throughout its term,~~ in accordance with paragraph 3865.07(c), the entity must expect the relationship to be effective in achieving offsetting changes in the fair value or cash flows of the hedged item and the hedging item that are attributable to the hedged risk exposure and occur during the term of the relationship. Effectiveness requires a high correlation of changes in fair values or cash flows. When the critical terms of the hedging item and the hedged item are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to offset completely at the inception of the hedging relationship and ~~on an ongoing basis throughout its term.~~
- .235** Effectiveness is assessed for periods up to the current balance sheet date (retroactively) to measure the extent of any actual ineffectiveness and to determine whether hedge accounting remains appropriate for the current fiscal period. Effectiveness is assessed prospectively to justify the assessment that the relationship will be effective. Effectiveness is assessed, at a minimum, quarterly.
- .246** A proper evaluation of the effectiveness of a hedging relationship requires a careful identification of the hedged item and the hedging item. For example, in the case of a receive-floating/pay-fixed interest rate swap used to offset the cash flow interest rate risk exposure on a floating-rate debt instrument (~~which is sometimes characterized as a synthetic fixed-rate instrument~~), the hedged exposure is the variability in the amount of future interest payments on the debt instrument, the hedged item is the stream of interest payments and the hedging item is the stream of net amounts receivable or payable on the swap. When the risk management objective is to achieve a fixed amount of net cash outflows on the items within the hedging relationship, the relationship is effective to the extent that the variability in the amount of the interest payments is offset by net amounts received or paid on the swap.
- .257** An entity assesses the effectiveness of its hedging relationships in light of its risk management objective and strategy. For example, an entity intending to protect an investment asset against the risk of a future loss may purchase an

“at-the-money” put option on that asset. The entity’s strategy is to achieve a one-sided offset of the hedged risk exposure against the intrinsic value of the option. The effectiveness of that hedging relationship would be assessed according to the extent to which increases in the intrinsic value of the option offset any decreases in the fair value of the investment asset in accordance with the entity’s risk management objective and strategy.

- .268** This ~~Guideline~~ Section does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness will depend on its risk management strategy. In some cases, an entity will adopt different methods for different types of hedges. An entity’s documentation of its risk management objective and strategy will include its procedures for assessing effectiveness. Those procedures may state, for example:
- (a) how frequently, and when, the assessment will be made;
 - (b) whether the retroactive aspect of the assessment will be made on a period-by-period basis or cumulatively over the term of the hedging relationship up to the assessment date; or
 - (c) how the assessment will deal with the time value of derivative hedging instruments.
- ~~.27~~ ~~An entity should disclose its accounting policies for assessing hedge effectiveness and recognizing in income the effects of any ineffectiveness in a hedging relationship.~~
- .289** Hedge accounting is not appropriate for non-monetary assets or liabilities in many circumstances because of an inability to demonstrate effectiveness. However, the conditions for hedge accounting may be satisfied in some circumstances involving non-monetary items, including:
- (a) existing or expected future contracts to purchase or sell non-monetary items, when the transactions will give rise to monetary assets or liabilities as consideration (see paragraphs ~~3865.323-~~356); and
 - (b) derivative or other contracts to deliver a commodity that hedge expected future production of that commodity.

Options

- .2930** An entity may purchase or write an option on an item exposed to a risk that it wishes to hedge. Such an arrangement may satisfy the requirement for hedge effectiveness and, accordingly, hedge accounting may be appropriate, only when:
- (a) in the case of a purchased put or call option, the option is intended to provide protection against loss on an item exposed to risk and is effective in doing so while “in-the-money”; and
 - (b) in the case of a written option, the combination of the hedged item and the written option provides:
 - (i) at least as much potential for gains as a result of a favourable change in the fair value of the combined instruments as exposure to losses from an unfavourable change in their combined fair value; or
 - (ii) at least as much potential for favourable cash flows as exposure to unfavourable cash flows.
- .301** Under the criteria in paragraph ~~3865.2930~~, a written option qualifies for hedge accounting when it is matched in combination with a purchased option, such that the amount of loss on one is offset by the gain on the other (i.e., when no

net premium is received, the underlying item of the options is the same, the notional amount of the written option is not greater than the notional amount of the purchased option, and both options mature at the same time). A written call option used to hedge an embedded call option in a debt instrument (a purchased call from the debtor's perspective) qualifies for hedge accounting. However, a written call option on an asset held by the entity (covered call) does not qualify for hedge accounting.

Tandem currencies

- .312** When the currencies of a hedged item and a hedging item differ, a foreign currency hedging relationship will be effective when a formal arrangement exists in one or both of the countries to maintain the exchange rate between the currencies. In the absence of such a formal arrangement, at the inception of a hedging relationship an entity needs to consider how it will be able to demonstrate that the hedging relationship will be effective.

Anticipated transactions

- .323** An anticipated transaction may be a hedged item. However, it may not be a hedging item. A hedging relationship involving an anticipated transaction may satisfy the conditions for hedge accounting only when it is probable that the anticipated transaction will occur at the time and in the amount expected, so that the relationship may be specifically identified and its effectiveness measured and assessed.
- .334** Factors to consider in determining whether it is probable that an anticipated transaction will occur at the time and in the amount expected include:
- (a) the existence of a firm commitment to undertake the anticipated transaction;
 - (b) the existence of similar transactions in the past;
 - (c) the financial and operational ability of the entity to carry out the anticipated transaction;
 - (d) the extent of the entity's current commitments of resources to the business activity of which the anticipated transaction is a part;
 - (e) the length of time to the date the anticipated transaction is expected to occur;
 - (f) the extent of loss or disruption to the entity if it does not undertake the anticipated transaction;
 - (g) the likelihood that another transaction might take place to achieve the same business purpose; and
 - (h) the likelihood that another party will be willing and able to undertake the anticipated transaction with the entity.
- .345** The occurrence of ~~an anticipated but uncommitted~~ a forecasted transaction may be probable when it is based on an entity's budget assumptions that reflect a historical pattern of similar transactions. For example, an entity may have a history of a consistent level of sales into a foreign market for a particular product line, and management is not aware of any changes in the foreign market indicating that this level of sales cannot be achieved in the upcoming year. In those circumstances, the occurrence of ~~an anticipated but uncommitted~~ a forecasted foreign currency transaction associated with those sales may be considered to be probable in both amount and timing. However, ~~an anticipated but uncommitted~~ a forecasted foreign currency transaction associated with

expected increased sales in a foreign market due, for example, to the introduction of a new product line would not be considered probable in either amount or timing due to the uncertainty of the increased sales.

- .356** An anticipated transaction is by its very nature uncertain, particularly when it is not the subject of a firm commitment. This uncertainty increases as the transaction is anticipated to occur further into the future. When management of an entity determines whether ~~an anticipated but uncommitted~~ forecasted transaction is probable, the time until the transaction is expected to occur will have to be considered. For example, management may consider 80 percent of sales expected in the next fiscal year to be probable but may consider only 50 percent of sales expected in three years' time to be probable. In most situations, in order to meet the probability criterion, only a proportion of ~~anticipated but uncommitted~~ forecasted transactions in a future period may be designated as a component of a hedging relationship. Other factors, such as the susceptibility of the transactions to changes in demands, or the risk of technological obsolescence in the underlying product, will also have an impact on the uncertainty associated with ~~anticipated but uncommitted~~ forecasted transactions.

PRESENTATION OF HEDGING ITEMS

- .367** Hedging items and hedged items are presented in the financial statements in the same manner as other assets and liabilities. For example, the requirements concerning offsetting of a financial asset and a financial liability in FINANCIAL INSTRUMENTS — DISCLOSURE AND PRESENTATION, Section 3860, apply to hedging items, ~~including the components of synthetic instruments.~~

HEDGE ACCOUNTING

Fair value hedges

- .38** ➤ *If a fair value hedge meets the conditions in paragraphs 3865.07-.36 during the financial reporting period, it should be accounted for as follows:*
- (a) *The gain or loss on a derivative hedging item should be recognized immediately in net income.*
 - (b) *The gain or loss on a non-derivative hedging item attributable to the hedged risk should adjust the carrying amount of the hedging item and be recognized immediately in net income.*
 - (c) *The gain or loss on the hedged item attributable to the hedged risk should adjust the carrying amount of the hedged item and be recognized immediately in net income. This applies even if a hedged item is otherwise measured at fair value with changes in fair value recognized in other comprehensive income, in accordance with FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, paragraph 3855.67(b). It also applies if the hedged item is otherwise measured at cost or amortized cost.*

(See paragraphs 3865.B1-.B2 for an illustrative example of how this paragraph applies to a hedge of an exposure to changes in the fair value of an investment in fixed rate debt as a result of a change in interest rates.)

- .39** If only particular risks attributable to a hedged item have been hedged, recognized changes in the fair value of the hedging item unrelated to the hedge are recognized in accordance with FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, paragraph 3855.67.
- .40** ➤ *An adjustment to the carrying amount of a hedged interest-bearing financial instrument should be amortized to net income. Amortization may begin as soon as an adjustment exists and should begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortization begins and should be amortized fully by maturity.*
- .41** A hedge of a firm commitment (for example, a hedge of the change in fuel price relating to an unrecognized contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is accounted for as a fair value hedge. However, when the risk being hedged is foreign currency risk (for example, a hedge of the foreign currency risk in a firm commitment by an airline to purchase an aircraft for a fixed amount of a foreign currency), an entity may account for the hedge as a cash flow hedge, in accordance with paragraphs 3865.42-.45.

Cash flow hedges

- .42** ➤ *If a cash flow hedge meets the conditions in paragraphs 3865.07-.31 during the financial reporting period, it should be accounted for as follows:*
- (a) the portion of the gain or loss on the hedging item that is determined to be an effective hedge (see paragraphs 3865.06-.35) should be recognized in other comprehensive income¹ (see COMPREHENSIVE INCOME, Section 1530); and*
 - (b) the ineffective portion of the gain or loss on the hedging item should be recognized:*
 - (i) immediately in net income if the hedging item is a derivative; or*
 - (ii) in accordance with FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, paragraph 3855.67 when the hedging item is not a derivative.*
- (See paragraphs 3865.B3-.B7 for an illustrative example of how this paragraph applies to a hedge of a floating rate liability with a pay-fixed/receive-floating interest rate swap.)
- .43** More specifically, a cash flow hedge is accounted for as follows:
- (a) accumulated other comprehensive income associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):
 - (i) the cumulative gain or loss on the hedging item from inception of the hedge, less any excluded component, in accordance with paragraph 3865.43(c); and
 - (ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;

¹ In the case of a not-for-profit organization, the equivalent gain or loss would be recorded in the statement of changes in net assets (see FINANCIAL STATEMENT PRESENTATION BY NOT-FOR-PROFIT ORGANIZATIONS, Section 4400).

- (b) any remaining gain or loss on the hedging item (which is not an effective hedge) is included in net income or in other comprehensive income, as appropriate, in accordance with paragraph 3865.42 and FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, paragraph 3855.67; and
- (c) if an entity's documented risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss or related cash flows on the hedging item from the assessment of hedge effectiveness (see paragraphs 3865.07 and 3865.10), that excluded component of gain or loss is recognized in accordance with FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, paragraph 3855.67.

- .44** ➤ *When a hedge of an anticipated transaction subsequently results in the recognition of an asset or a liability, the associated gains or losses that were recognized in other comprehensive income in accordance with paragraph 3865.42 should be reclassified into net income in the same period or periods during which the asset acquired or liability incurred affects net income (such as in the periods that depreciation expense, interest expense or cost of sales is recognized). However, if an entity expects at any time that all or a portion of a net loss recognized in other comprehensive income will not be recovered in one or more future periods, it should reclassify immediately into net income the amount that is not expected to be recovered.*
- .45** ➤ *For all cash flow hedges other than those covered by paragraph 3865.44, amounts that had been recognized in other comprehensive income should be included in net income in the same period or periods during which the hedged anticipated transaction affects net income (for example, when a forecast sale actually occurs).*

Hedges of a net investment in a self-sustaining foreign operation

- .46** ➤ *A hedge of a net investment in a self-sustaining foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see FOREIGN CURRENCY TRANSLATION, Section 1650), should be accounted for similarly to a cash flow hedge:*
- (a) *the portion of the gain or loss on the hedging item that is determined to be an effective hedge (see paragraphs 3865.07-.36) should be recognized in other comprehensive income² (see COMPREHENSIVE INCOME, Section 1530); and*
 - (b) *the ineffective portion should be recognized:*
 - (i) *immediately in net income if the hedging item is a derivative; or*
 - (ii) *in accordance with FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, paragraph 3855.67, when the hedging item is not a derivative.*

The gain or loss on the hedging item relating to the effective portion of the hedge that has been recognized in other comprehensive income should be recognized in net income in the same period as corresponding exchange gains or losses arising from the translation of the financial statements of the self-sustaining foreign operation are recognized in net income.

² In the case of a not-for-profit organization, the equivalent gain or loss would be recorded in the statement of changes in net assets (see FINANCIAL STATEMENT PRESENTATION BY NOT-FOR-PROFIT ORGANIZATIONS, Section 4400).

Hedges that do not qualify for hedge accounting

- .47 If a hedge does not qualify for hedge accounting because it fails to meet the criteria in paragraphs 3865.07-.36, gains and losses arising from changes in the fair value of a hedged item that is measured at fair value after initial recognition are recognized in accordance with measurement rules applicable if it had not been hedged. Fair value adjustments of a hedging item that is a derivative would be recognized in net income.

Discontinuing hedge accounting

.3748 ➤ An entity *should* discontinue hedge accounting when a hedging relationship ceases to satisfy the conditions for hedge accounting. Those conditions cease to be satisfied 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 entity terminates its designation of the hedging relationship; or
- (d) the hedging relationship ceases to be effective (see paragraph 3865.223).

A hedging relationship involving an anticipated transaction fails to satisfy the conditions for hedge accounting when it is no longer probable that the anticipated transaction will occur substantially as and when identified on inception of the hedging relationship.

.3849 The accounting consequences of ceasing to satisfy the conditions for hedge accounting depend on the circumstances.

- (a) When a hedging item ceases to exist as a result of its maturity, expiry, sale, termination, cancellation or exercise and is not replaced as part of the entity's documented hedging strategy, any gains, losses, revenues or expenses associated with the hedging item that had been ~~deferred-recognized in other comprehensive income~~ previously as a result of applying hedge accounting are carried forward to be recognized in net income in the same period as the corresponding gains, losses, revenues or expenses associated with the hedged item.
- (b) When a hedged item ceases to exist as a result of its maturity, expiry, sale, termination, cancellation or exercise, any gains, losses, revenues or expenses associated with the hedging item that had been ~~deferred-recognized in other comprehensive income~~ previously as a result of applying hedge accounting are recognized in the current period's income statement along with the corresponding gains, losses, revenues or expenses recognized on the hedged item. This treatment applies when it is no longer probable that an anticipated transaction will occur substantially as and when identified on inception of the hedging relationship.
- (c) When an entity terminates its designation of a hedging relationship or a hedging relationship ceases to be effective, hedge accounting is not applied to gains, losses, revenues or expenses arising subsequently. However, the hedge accounting applied to the hedging relationship in prior periods is not reversed. Any gains, losses, revenues or expenses ~~deferred-recognized in other comprehensive income~~ previously as a result of applying hedge accounting continue to be carried forward for subsequent recognition in net income in the same period as the corresponding gains, losses, revenues or expenses associated with the hedged item.

DISCLOSURE

- .50** ➤ *An entity that holds or issues derivatives, non-derivative financial assets or non-derivative financial liabilities that are designated and qualify as hedging items should disclose information that enables users of the financial statements to understand its objectives for holding or issuing those items, the context needed to understand those objectives, and its strategies for achieving those objectives.*
- .51** To give effect to the principle in paragraph 3865.50, the description distinguishes between at least the following:
- (a) derivatives and non-derivative financial instruments designated as fair value hedging items;
 - (b) derivatives and non-derivative financial instruments designated as cash flow hedging items;
 - (c) derivatives and non-derivative financial instruments designated as hedging items for hedges of the foreign currency exposure of the net investment in a self-sustaining foreign operation; and
 - (d) all other derivatives.
- .52** The description in accordance with paragraph 3865.50 would indicate the entity's risk management policy for each of the types of hedges in paragraphs 3865.51(a)-(c), including a description of the items or transactions for which risks are hedged.
- .53** Disclosures about an entity's objectives and strategies, in accordance with paragraph 3865.50, are generally more meaningful if objectives and strategies are described in the context of an entity's overall risk management profile.
- .54** ➤ *An entity that holds or issues derivatives, non-derivative financial assets or non-derivative financial liabilities that are designated and qualify as hedging items should disclose information that enables users of the financial statements to understand the effect of hedge accounting on the financial statements.*
- .55** To give effect to the principle in paragraph 3865.54, an entity discloses at least the following:
- (a) For fair value hedges:
 - (i) the net gain or loss recognized in net income during the reporting period representing the amount of the hedge's ineffectiveness;
 - (ii) the net gain or loss recognized in net income during the reporting period representing the component of the hedging item's gain or loss, if any, excluded from the assessment of effectiveness;
 - (iii) a description of where the net gains or losses in items (i) and (ii) are reported in the income statement; and
 - (iv) the amount of the net gain or loss recognized in net income when a hedged firm commitment no longer qualifies as a fair value hedge.
 - (b) For cash flow hedges:
 - (i) the net gain or loss recognized in net income during the reporting period, representing the amount of the hedge's ineffectiveness;
 - (ii) the net gain or loss recognized in net income during the reporting period, representing the component of the hedging item's gain or loss, if any, excluded from the assessment of effectiveness;

- (iii) a description of where the net gains or losses in items (i) and (ii) are reported in the income statement;
 - (iv) a description of the transactions or other events that will result in the reclassification to net income of gains and losses that are reported in accumulated other comprehensive income;
 - (v) the estimated net amount of existing gains and losses reported in accumulated other comprehensive income that is expected to be reclassified to net income within the next twelve months;
 - (vi) the maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for anticipated transactions, excluding those anticipated transactions related to the payment of variable interest on existing financial instruments; and
 - (vii) the amount of gains and losses reclassified to net income as a result of the discontinuance of cash flow hedges because it is probable that the original anticipated transactions will not occur by the end of the originally specified time period.
- (c) For hedges of the foreign currency exposure of the net investment in a self-sustaining foreign operation, the net amount of gains or losses included in other comprehensive income during the reporting period.

.756 An entity discloses its accounting policy for hedging relationships, including its policy for assessing hedge effectiveness, in accordance with DISCLOSURE OF ACCOUNTING POLICIES, Section 1505.

TRANSITIONAL PROVISIONS

- .57** This Section applies for financial statements covering fiscal years beginning on or after October 1, 2004. Retroactive application is not permitted. Earlier application is encouraged only as of the beginning of a fiscal year that ends after the date of issue of this Section [date to be inserted].
- .58** The transition to this Section is as follows:
- (a) Hedge accounting policies followed in financial statements for periods prior to the effective date of this Section are not reversed and, therefore, those financial statements are not restated.
 - (b) For hedging relationships entered into before the beginning of the fiscal year in which this Section is initially applied that the entity previously designated as hedges, the provisions of this Section are applied prospectively. Therefore, if the previously designated hedge does not meet the conditions for hedge accounting set out in paragraphs 3865.07-.36 and the hedging item is still held, hedge accounting is no longer appropriate, starting with the beginning of the fiscal year in which this Section is initially applied.
 - (c) At the beginning of the fiscal year in which this Section is initially applied, any balance sheet positions in fair value hedges of existing assets and liabilities are accounted for by adjusting their carrying amounts to reflect the fair value of the hedging item. Any difference in carrying amount is recognized as an adjustment of the balance of retained earnings at the beginning of the fiscal year in which this Section is initially applied.
 - (d) If an entity's hedge accounting policies prior to initial application of this Section had included deferral, as assets and liabilities, of gains or losses on cash flow hedges at the beginning of the fiscal year in which this

Section is initially applied, those deferred gains and losses are reclassified to accumulated other comprehensive income to the extent that the transactions meet the conditions for applying hedge accounting in paragraphs 3865.07-.36 and, thereafter, accounted for in accordance with paragraphs 3865.44-.45. If the conditions in paragraphs 3865.07-.36 are not met, paragraph 3865.58(b) applies.

- (e) Transactions entered into before the beginning of the fiscal year in which this Section is initially applied are not retroactively designated as hedges.

APPENDIX A

APPLICATION SUPPLEMENT

This Appendix is an integral part of this Section.

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TYPES OF HEDGING RELATIONSHIPS

~~A1 A hedging relationship in which changes in fair values are offset is referred to in this Guideline as a fair value hedge, and a hedging relationship in which changes in cash flows are offset is referred to as a cash flow hedge.~~

HEDGING ITEMS WITH EMBEDDED DERIVATIVES

~~A21 For fair value hedges of financial instruments, the effect of an embedded derivative is considered in designating a hedge of an individual risk and assessing its effectiveness. For example, the effect of an embedded prepayment option is considered in designating a hedge of interest rate risk and assessing the effectiveness of that hedging relationship. However, an entity may designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the overall fair value of that prepayment option, with the objective of hedging prepayment risk, when the other conditions in paragraph 3865.06 have been satisfied.~~

THE EFFECT OF TIME VALUE ON HEDGE EFFECTIVENESS ASSESSMENT

~~A32 Changes in fair values or cash flows arising primarily from the passage of time may be excluded from the assessment of hedge effectiveness in the following circumstances.~~

- ~~(a) When the effectiveness of a hedging relationship involving an option contract is assessed based on changes in the option's intrinsic value, the change in the time value of the contract may be excluded from the assessment of hedge effectiveness.~~
- ~~(b) When the effectiveness of a hedging relationship involving an option contract is assessed based on changes in the option's minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract may be excluded from the assessment of hedge effectiveness.~~
- ~~(c) When the effectiveness of a hedging relationship involving a forward or futures contract is assessed based on changes in spot prices, the changes in the difference between the spot price and the forward or futures price may be excluded from the assessment of hedge effectiveness.~~

EFFECTIVENESS TESTS WHERE THE CRITICAL TERMS OF THE HEDGED ITEM AND THE HEDGING ITEM MATCH

- A43 An entity may assume that there is no ineffectiveness in a hedge of an anticipated purchase of a commodity with a forward contract when:
- (a) the forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged anticipated purchase;
 - (b) the fair value of the forward contract at inception is zero; and
 - (c) either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness, or the change in expected cash flows on the anticipated transaction is based on the forward price for the commodity.
- A54 An entity may assume that there is no ineffectiveness in a hedge of interest rate risk involving a recognized interest-bearing asset or liability and an interest rate swap when all of the applicable conditions in the following list are met:
- (a) The notional amount of the swap matches the percentage of the principal amount of the interest-bearing asset or liability that is designated as the hedged item.
 - (b) The fair value of the swap at the inception of the hedging relationship is zero.
 - (c) The formula for computing net settlements under the interest rate swap is the same for each net settlement. That is, 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.
 - (d) The interest-bearing asset or liability is not prepayable (that is, able to be settled by either party prior to its scheduled maturity), except as follows:
 - (i) This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option, provided that the hedging interest rate swap contains an embedded mirror-image call option. The call option embedded in the swap is considered a mirror image of the call option embedded in the hedged item when the terms of the two call options match (including matching maturities, strike price, related notional amounts, timing and frequency of payments, and dates on which the instruments may be called), and the entity is the writer of one call option and the holder (or purchaser) of the other call option.
 - (ii) This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded put option, provided that the hedging interest rate swap contains an embedded mirror-image put option.
 - (e) 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.
 - (f) Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.
 - (g) The currency of one leg of the swap is the same as the currency of the underlying asset or liability and the currency of the other leg of the swap is the same as the currency in which the entity measures the underlying asset or liability in its financial statements.

For fair value hedges only

- (h) The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.
- (i) There is no floor or ceiling on the variable interest rate of the swap.
- (j) 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).

For cash flow hedges only

- (k) All interest receipts or payments on the variable rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.
- (l) There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or a cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability.
- (m) The repricing dates match those of the variable-rate asset or liability.

ILLUSTRATIVE EXAMPLES

These illustrative examples indicate how the accounting treatment specified in this Section might be applied in particular situations. They are illustrative only and matters of principle relating to particular situations should be decided in the context of the Section.

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FAIR VALUE HEDGES

- B1 The following example illustrates how paragraph 3865.38 applies to a hedge of exposure to changes in the fair value of an investment in fixed rate debt as a result of changes in interest rates. This example is presented from the perspective of the holder.
- B2 In Year 1 an investor purchases for \$100 a debt security that is classified as available for sale in accordance with FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, Section 3855. At the end of Year 1, current fair value is \$110. Therefore, the increase of \$10 is recognized in other comprehensive income, and the carrying amount is increased to \$110 in the balance sheet. To protect the value of \$110, the holder acquires a derivative at the beginning of Year 2 with no cost. By the end of Year 2, the derivative has a gain of \$5, and the debt security has a corresponding decline in fair value.

Journal entries in investor's books, Year 1:

Dr. Investment in debt security	\$100	
Cr. Cash		\$100
To reflect the purchase of the security		
Dr. Investment in debt security	\$ 10	
Cr. Increase in fair value (included in other comprehensive income)		\$ 10
To reflect the increase in fair value of the security		

Journal entries in investor's books, Year 2:

Dr. Derivative asset	\$ 5	
Cr. Gain (included in net income)		\$ 5
To reflect the increase in fair value of the derivative		
Dr. Loss (included in net income)	\$ 5	
Cr. Investment in debt security		\$ 5
To reflect the decrease in fair value of the debt security		

The carrying amount of the debt security is \$105 at the end of Year 2, and the carrying amount of the derivative is \$5. The gain of \$10 is recognized in other comprehensive income until the debt security is derecognized or impaired, and is subject to amortization in accordance with FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, paragraph 3855.67.

CASH FLOW HEDGES

- B3 The following example illustrates the application of the principles of this Section to the recognition and measurement of ineffectiveness for a cash flow hedge.
- B4 Entity A has a floating rate liability of \$1,000 with five years remaining to maturity. It enters into a five-year pay-fixed/receive-floating interest rate swap in the same currency and with the same principal terms as the liability to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk. At inception, the fair value of the swap is zero. Subsequently, there is an increase of \$49 in the fair value of the swap. This increase consists of a change of \$50 resulting from an increase in market interest rates and a change of minus \$1 resulting from an increase in the credit risk of the swap counterparty. There is no change in the fair value of the floating rate liability, but the fair value (present value) of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by \$50.
- B5 A hedge of interest rate risk is not fully effective if part of the change in the fair value of the derivative is attributable to the counterparty’s credit risk. However, because Entity A determines that the hedge relationship is still effective, it credits the effective portion of the change in fair value of the swap (i.e., the net change in fair value of \$49) to other comprehensive income. There is no debit to net income for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item (i.e., \$50) exceeds the cumulative change in value of the hedging item (i.e., \$49).

Journal entry in Entity A’s books:

Dr. Swap	\$49	
Cr. Other comprehensive income		\$49
To reflect the increase in fair value of the derivative		

- B6 If Entity A concludes that the hedge is no longer effective, it discontinues hedge accounting prospectively as from the date the hedge ceased to be effective, in accordance with paragraphs 3865.37-.38.
- B7 If the fair value of the swap instead increases to \$51, of which \$50 results from the increase in market interest rates and \$1 from a decrease in the credit risk of the swap counterparty, there is a credit to net income of \$1 for the change in fair value of the swap attributable to the improvement in the credit quality of the swap counterparty. This is because the cumulative change in the value of the hedging item (i.e., \$51) exceeds the cumulative change in the present value of the future cash flows needed to offset the exposure to variable

interest cash flows on the hedged item (i.e., \$50). The difference of \$1 represents the excess ineffectiveness attributable to the derivative hedging instrument, the swap, and is recognized in net income.

Journal entry in Entity A's books:

Dr. Swap	\$51	
Cr. Other comprehensive income		\$50
Cr. Net income		\$ 1
To reflect the increase in fair value of the derivative		

CONSEQUENTIAL AMENDMENTS

The following significant consequential amendments have been identified:³

FOREIGN CURRENCY TRANSLATION, Section 1650

On finalizing this proposed Handbook Section, paragraphs 1650.47-.55 would be deleted.

FINANCIAL INSTRUMENTS — DISCLOSURE AND PRESENTATION, Section 3860

On finalizing this proposed Handbook Section, paragraphs 3860.92-.93 would be deleted.

ACCOUNTING GUIDELINE AcG-13, Hedging Relationships

This Guideline would be withdrawn.

³ Other amendments of an editorial or cross-referencing nature may also be necessary, as well as amendments to other sources of GAAP such as EIC Abstracts.