

ACCOUNTING PRINCIPLES FOR DERIVATIVE INSTRUMENTS

**Ministry of Finance
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Introduction

The following are guidelines on the accounting methods and disclosure of derivative instruments for Ontario's credit unions and caisses populaires. Unless otherwise stated, the requirements outlined in this paper apply to leagues.

Definitions

Financial derivatives are financial contracts whose values are derived from the value of an underlying asset or index such as : interest rates, exchange rates, commodities, equities, debt obligations, indexes.

An option is a financial contract to buy or sell a standard quantity of a specified underlying asset on a specified future date at an agreed price.

Interest rate swap is an agreement between two parties to exchange interest payments, usually in which one party agrees to make payments, at a fixed interest rate and the other party agrees to make payments at a floating interest rate, predicated on notional principal value.

Interest rate swaps

If a credit union/caisse populaire enters into an interest rate swap or similar agreement, and the purpose of the transaction is to hedge against interest rate or similar risk associated with its specific assets and liabilities or groups of specific assets and liabilities through a compensatory price movement contract, the net interest shall be recorded in the income accounts as it occurs.

Initial recognition of a financial derivative

A financial derivative should be recognized on a credit union/caisse populaire's balance sheet when:

- (a) substantially all of the risks or rewards associated with the asset or liability have been transferred to the credit union/caisse populaire; and
- (b) the cost or fair value of the asset to the credit union/caisse populaire or the amount

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of the obligation assumed can be measured reliably.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Identification of a hedge

A derivative instrument should be accounted for as a hedge when:

- the position to be hedged is specifically identified and exposes the credit union to risk of loss from price/interest rate changes;
- the instrument is specifically designated as a hedge in minutes of a meeting of the board of directors;
- it is clear that changes in the fair value of the instrument designated as a hedge and opposite changes in the fair value of the position being hedged will correlate closely, so that the hedging instrument will be effective in eliminating or substantially reducing the risk of loss from the position being hedged.

Income recognition of gain or loss on a hedging instrument

In general, a gain or loss from a change in the fair value of a financial instrument accounted for as a hedge should be recognized in income when the corresponding loss or gain from a change in the fair value of the hedged position is recognized in income.

Discontinuance of hedge accounting

If a financial derivative classified as a hedge ceases to satisfy all of the conditions noted above, on the date it ceases to do so, the hedging instrument should be reclassified in accordance with the following paragraph.

Financial derivatives shall be marked-to-market daily on an individual contract basis, any unrealized loss or gain shall be recognized on that basis in the income accounts.

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General disclosure requirements

For each type of derivative instrument, whether recognized or unrecognized, a credit union/caisse populaire should disclose information about the extent and nature of these instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows.

Disclosures concerning hedges of anticipated future transactions

When a credit union/caisse populaire has designated a financial instrument as a hedge of an identified future transaction, it should disclose in the audited financial statements or note thereof:

- (a) the nature of the identified transaction;
- (b) the amount of the deferred or unrecognized gain or loss; and
- (c) the period of time until the anticipated transaction is expected to occur.

Conclusion

The principles outlined in this paper should help credit unions and caisses populaires and their auditors account for and disclose their investments in derivatives in an appropriate and consistent manner.