

Financial Instruments — Background Information and Basis for Conclusions

Section 3856

Foreword

In February 2022, the Accounting Standards Board (AcSB) amended FINANCIAL INSTRUMENTS, Section 3856 in Part II of the CPA Canada Handbook – Accounting. The AcSB has approved for publication the contents of this document setting out its rationale for the amendments.

Background Information and Basis for Conclusions documents are sources of generally accepted accounting principles, as described in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100 in Part II of the Handbook. These documents are intended to help readers understand how the AcSB reached its conclusions, but they do not include explanations of requirements or guidance on the application of the relevant Section or Accounting Guideline.

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INTRODUCTION

- 1 This document summarizes considerations that were deemed significant by AcSB members in reaching their conclusions to amend FINANCIAL INSTRUMENTS, Section 3856 in Part II of the CPA Canada Handbook – Accounting. This document sets out the reasons the Board undertook the project to develop the amendments, the process of research and deliberation, the key decisions made and the principal reasons for adopting the positions taken and rejecting others. Individual Board members gave greater weight to some factors than to others.
- 2 Nothing in this document is to be taken as overriding the requirements of the Handbook. However, the discussion may help readers understand how the AcSB reached its conclusions in developing the amendments and the Board's intent with respect to its interpretation and application.

APPLICABILITY TO NOT-FOR-PROFIT ORGANIZATIONS

- 3 Section 3856 in Part II of the Handbook applies to private enterprises as well as to not-for-profit organizations (NFPOs) applying the standards in Part III of the Handbook, as relevant. In finalizing the amendments and in light of the feedback received, the AcSB concluded there were no unique considerations for NFPOs applying these amendments.

BACKGROUND

- 4 Following the recommendations from the Financial Stability Board's report, "Reforming Major Interest Rate Benchmarks," many jurisdictions, including Canada, are replacing existing IBORs with alternative benchmark rates

(IBOR reform). For example, London Interbank Offered Rate (LIBOR) is expected to be discontinued after December 2021. Although the Canadian Dollar Offered Rate (CDOR), Canada's IBOR, is not anticipated to be immediately replaced, its relevance is expected to decline and ultimately it will be discontinued. 1

- 5 In April 2021, the AcSB approved a project to consider the financial reporting implications of IBOR reform. The Board's objective for the project is to provide necessary relief to minimize any operational burden and interruptions IBOR reform causes for Canadian entities. Specifically, the Board identified two issues that could have financial reporting implications in Canada:
- (a) **Debt modification versus extinguishment:** the "10 percent" requirement prescribed in paragraph 3856.A52 to assess whether the debt modification is substantial could be onerous to perform for enterprises with a high volume of IBOR-based financial assets or financial liabilities.
 - (b) **Hedge accounting:** as the hedged item and hedging item designated in a qualifying hedging relationship are modified to replace IBOR with an alternative benchmark rate, the originally designated hedging relationship will cease to exist. In accordance with paragraph 3856.35, the enterprise shall discontinue hedge accounting.
- 6 The AcSB considered whether to provide relief to lease contracts that refer to IBOR given the modification of a benchmark will require an enterprise to reconsider existing leases as new leases. Based on the feedback received from its Private Enterprises Advisory Committee and Not-for-Profit Advisory Committee, the Board understands that it is uncommon for Canadian private enterprises to hold IBOR-based lease contracts. Therefore, the Board decided against providing such relief because the cost of doing so would outweigh the benefits the relief may provide.
- 7 In September 2021, the AcSB issued its Exposure Draft, "Financial Instruments." In developing these proposals, the Board sought the advice of its Private Enterprises Advisory Committee and Not-for-Profit Advisory Committee. These Committees include financial statement users, auditors and preparers, with a range of backgrounds and experience from across Canada. Committee members include representatives from organizations of differing sizes and in a variety of industries.
- 8 The AcSB received eight written responses to the Exposure Draft from four public accounting firms, three financial statement preparers and one individual. Respondents generally supported the Board's proposal to provide an optional expedient for applying debt modification accounting and an exception to certain hedge accounting requirements in Section 3856, to ease the financial reporting burdens related to IBOR reform. However, some respondents provided additional comments suggesting changes to some of the proposals. The specific issues addressed in this project, including the substantive comments received on the Exposure Draft and any changes made in response to those comments, are highlighted in the sections that follow.

EFFECT ANALYSIS

- 9 The amendments to Section 3856 provide temporary guidance that would:
- (a) simplify accounting analysis under current guidance in Section 3856 for debt modifications; and
 - (b) require hedging relationships to continue upon a change in certain critical terms.
- 10 A primary benefit of the amendments is the cost savings provided to many financial statement preparers to reduce the effort needed to assess whether a modification that is directly related to IBOR reform should be accounted for as an extinguishment. In addition, allowing effective hedging relationships to continue presents decision-useful information to financial statement users.

OPTIONAL EXPEDIENTS FOR ACCOUNTING FOR DEBT MODIFICATIONS

Need for relief

- 11 The AcSB noted that the current guidance on debt modification in Section 3856 is adequate when assessing whether a contract modification should be accounted for as an extinguishment. Under the current guidance, an enterprise assesses both qualitatively and quantitatively, using the 10 percent test, to determine whether a modified contract substantially differs from the original contract. The Board understood that under the current guidance, loans that are modified solely to reflect the effects of IBOR reform are likely to be accounted as a debt modification on an individual contract basis.
- 12 The AcSB understood that for enterprises that have a high volume of debt contracts modified because of IBOR reform, performing formal quantitative and qualitative assessments may be burdensome. Therefore, in such situations, the Board thought that relief to bypass this assessment and account for the qualifying amendments as a debt modification can alleviate an operational burden for preparers.

Scope of the relief

- 13 The AcSB decided to limit the relief to debt instruments that reference IBORs, such as CDOR or LIBOR. The Board decided to explicitly reference CDOR and LIBOR to highlight that the primary objective of the amendments is to facilitate the transition from IBORs to an alternative risk-free benchmark. In addition, explicitly referencing CDOR and LIBOR may help stakeholders identify whether the contract is in scope, considering the prominence of CDOR-based contracts in the Canadian market.
- 14 The AcSB decided the scope of the debt modifications eligible for the optional expedient would include only changes to terms directly related to IBOR reform. Such changes will affect, or have the potential to affect, the amount or timing of

future cash flows of a debt instrument. This would include contract terms such as fallback provisions triggered upon a contingent event (e.g., the discontinuance of rates).

- 15 The AcSB noted that other modifications to contracts that occur in the ordinary course of business or for reasons unrelated to IBOR reform do not qualify for the optional expedient. To reduce the effort in identifying which replacements qualify for relief, the Board decided to provide common examples of changes that are related to replacing IBOR and those that are not. Paragraphs 3856.A54A-.A54B list some but not all the changes to terms that may be considered related or unrelated to the replacement of IBORS.

Practical expedient for debt modifications

- 16 The Exposure Draft proposed a practical expedient in paragraph 3856.29A to account for the qualifying debt modifications as a continuation of the existing contract rather than an extinguishment of the contract and the establishment of a new contract. The enterprise should follow paragraph 3856.A55 to account for these modifications.
- 17 If the modification does not meet the criteria to apply the optional expedient, the debt modification would be assessed using the guidance in Section 3856 to determine whether the change is substantial.
- 18 The AcSB decided to make this practical expedient optional to offer enterprises the flexibility to apply this relief based on their own circumstances. The Board also decided this practical expedient, if elected, should be applied to all qualifying loan contracts to ensure consistent application.
- 19 The AcSB noted that IBOR reform does not affect transactions between related parties to modify the terms of an existing financial liability. Modifications of loans between related parties are accounted for as extinguishments under Section 3856. However, related party loans are measured at cost, which is based on the undiscounted cash flows excluding interest and dividend payments. Therefore, a change to the interest rate associated with the loan will not affect the carrying amount of that instrument and, therefore, no gain or loss would result from these transactions.
- 20 All respondents to the Exposure Draft agreed with the principle to provide a practical expedient for debt modifications and that the expedient should be optional. Some respondents noted that the proposed wording in paragraph 3856.29C was unclear with respect to accounting for modifications to a contract that include both changes in scope of the optional practical expedient and those that go beyond those "related to the replacement of IBOR with an alternative benchmark rate." The AcSB acknowledged this concern and noted that this practical expedient only applies to the changes to contract terms that are related to the replacement of IBOR. Therefore, when modifications to a contract include changes that are both related and unrelated to IBOR reform, the Board decided that the practical expedient should be applied first to those changes that are related to IBOR reform. The enterprise shall then apply the application requirements in Section 3856 to any additional changes to which the practical expedient does not apply. The Board thus revised paragraph 3856.29C to clarify this point.

HEDGE ACCOUNTING

- 21 The hedging item and the hedged item may be modified because of IBOR reform. When these items are modified, the original designated hedging relationship no longer exists. In addition, the hedging item and the hedged item may be updated at different times, leading to a mismatch in critical terms. The AcSB noted that the guidance in Section 3856 is clear that such changes to critical terms would cause a discontinuation of hedge accounting.
- 22 The AcSB thought that this financial reporting outcome does not provide decision-useful information to users if hedge accounting is discontinued solely because the terms need to be modified due to IBOR reform. In most cases, enterprises will continue to use modified derivatives for the same risk management purposes as before the modification.
- 23 Therefore, the AcSB proposed amendments to require the continuation of hedge accounting if the changes to the contractual terms meet the criteria for contractual modifications related to IBOR reform. The exception for changes in critical terms would apply to the following two hedging relationships that could be affected by IBOR reform:
- An interest-bearing asset or liability hedged with an interest rate swap to mitigate the effect of changes in interest rates (see paragraph 3856.32(c)); and
 - A foreign currency denominated interest-bearing asset or liability hedged with a cross-currency interest rate swap to mitigate the effect of changes in interest rates and foreign currency exchange rates (see paragraph 3856.32(d)).
- 24 Furthermore, the AcSB clarified that any updates to the hedge documentation required to reflect the changes to the critical terms do not constitute a discontinuation of the old hedging relationship nor a designation of a new hedging relationship.
- 25 The AcSB noted the relief given should be temporary to facilitate IBOR transition. Therefore, the Board decided that the exception provided to the hedge accounting requirements will end when all changes related to the replacement of IBOR have been made to the hedged item and hedging item. However, the Board also recognized that there could be scenarios where the critical terms in the hedged item and hedging item may be replaced at different times. In that case, there may be a temporary period where there is a mismatch between the hedged item and the hedging item. The Board decided that the exception should apply during this temporary period. However, the Board noted that this should only be a temporary situation and the enterprise must be actively seeking to ensure the outstanding rate is replaced during this period.

26 All respondents to the Exposure Draft agreed with the proposed exception in Section 3856 to require the continuation of hedge accounting when one or more critical terms change as a direct consequence of IBOR reform. Therefore, the AcSB made no changes to the exception to hedge accounting requirements.

DISCLOSURE

- 27 The AcSB decided that an enterprise should disclose the nature and the carrying amount of the financial instruments subject to IBOR reform. The Board noted this disclosure will highlight to financial statement users the effect of IBOR reform on an enterprise.
- 28 One respondent questioned whether the proposed disclosure requirement adequately highlights to the financial statement users the effect of IBOR reform on an enterprise. This respondent suggested additional disclosures should be provided, such as
- (a) whether an entity has elected to apply the optional expedient for debt modifications that are related to IBOR reform;
 - (b) for debts to which the optional expedient has been applied, the related financial statement impact and the carrying amount of such debts; and
 - (c) specific hedges impacted by IBOR reform and their financial statement impacts.
- 29 The AcSB discussed this feedback and after considering the advice of its user members of the Board and the Private Enterprises Advisory Committee. The Board concluded that the value derived from these additional disclosures is limited for financial statement users. The Board notes that for debt modifications to qualify for the optional expedient, the changes to cash flows resulting from the modification should not be significant. Hence, the related financial statement impact of such debt modifications is likely not material for financial statement users. The Board also considered that the purpose of this practical expedient is to alleviate the operational burden for preparers. Therefore, whether the optional expedient is applied offers little value to financial statement users.
- 30 On separate disclosure of specific hedges impacted by IBOR reform, the AcSB notes that this information is already required to be disclosed under paragraph 3856.51. Paragraph 51 requires the enterprise to disclose information that enables financial statement users to understand the effect of hedge accounting. Specifically, for a hedge of an interest-bearing asset or liability, the enterprise shall disclose the nature and terms of the hedged item, the nature and terms of the hedging interest rate swap, the fact that hedge accounting applies, and the net effect of the relationship. Therefore, by applying the exception, the enterprise will continue the hedging relationship and should continue disclosing the information required by paragraph 51.
- 31 Some respondents recommended also requiring disclosure of the notional amount of derivatives subject to IBOR reform. Interest rate swaps that are in qualifying hedging relationships are off balance sheet with no carrying amount and, thus, may be considered excluded from the scope of the disclosures as proposed in the Exposure Draft. However, the respondents noted that communicating the extent of IBOR reform exposure on both hedging and non-hedging derivatives would be useful. The AcSB agreed with this recommendation and added a requirement to disclose the notional amount of derivatives subject to IBOR reform.

EFFECTIVE DATE AND TRANSITION

- 32 Selecting an effective date for amendments is an important step in the AcSB's due process. The Board considered the expected discontinuance of LIBOR after December 31, 2021, and acknowledged the urgency of the amendments. The Board proposed these amendments be effective for fiscal years ending on or after February 1, 2022. The Board also proposed to permit earlier application, which includes financial statements not yet authorized for issue. This allows enterprises to apply the amendments to financial statements with fiscal years ending before February 1, 2022. All respondents to the Exposure Draft agreed with these proposals.
- 33 The AcSB decided that the amendments be applied retrospectively, as defined in paragraph 1506.05(d). Prospective application would have resulted in enterprises applying the amendments only if the transition to alternative benchmark rates occurred after the amendments are applied.
- 34 The AcSB understood an enterprise may modify a hedging relationship before the amendments are first applied and that in the absence of the amendments, the hedging relationship would be discontinued. To ensure the relief is applied consistently for all qualifying modifications to hedging relationships regardless of when they occur, the Board proposed to require the enterprise to reinstate hedging relationships that were discontinued solely due to changes required by IBOR reform before an enterprise first applies the amendments.
- 35 Some members of the Not-for-Profit Advisory Committee prior to the Exposure Draft questioned whether the requirement to reinstate the discontinued hedging relationship would be onerous and should be optional instead. This feedback was raised again by some respondents to the Exposure Draft. The Board deliberated this feedback before and after the Exposure Draft and concluded that reinstatement would be required because:
- (a) the occurrence of reinstatement would be rare, given CDOR is not expected to discontinue before the effective date.
 - (b) Section 3856 does not allow hedge accounting to be discontinued voluntarily. Therefore, enterprises should not be permitted to discontinue hedge accounting solely due to IBOR reform.

- (c) Providing an option to reinstate the discontinued relationship would result in an inconsistent application of the relief for similar hedging relationships and reduce the comparability between financial statements.
- 36 The retrospective approach does not permit the designation of hedging relationships in hindsight. Retrospectively applying the amendments does not allow the enterprise to apply hedge accounting to relationships not designated for hedge accounting prior to the first application of the amendments.
- CONSEQUENTIAL AMENDMENTS**
- 37 As part of the amendments to Section 3856 discussed above, there were no significant consequential amendments to other Sections in Part II of the Handbook.
- EXPOSURE FOR COMMENT**
- 38 After resolving the issues arising from the Exposure Draft process, the AcSB considered, as part of its due process, whether the revisions to the proposals should be exposed for comment.
- 39 The revisions have been highlighted in the relevant sections throughout this Basis for Conclusions. These revisions consist of changes and clarifications to reduce complexity, based on feedback received from stakeholders. Other than the changes and clarifications already highlighted in this Basis for Conclusions, only minor drafting changes were made. Therefore, the AcSB decided that there was no need for re-exposure.
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Footnotes

1. CARR, *Canadian Interest Rate Benchmark Reform*.

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